Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM 1977

No. 77-940

HENRY A. SINGER,

Petitioner,

v.

DAVID GOLDBERG suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC., YAACOV MERIDOR, MILA BRENER, ARA A. CAMBERE, H. STRUVE HENSEL, DAVID MERIDOR, S. ERELL, GIDEON BEN-AARON, HAIM RAFAELI, JACOB SUTTON, MARTIN SIEM, MARITIMECOR, S.A., MARITIME FRUIT CARRIERS COMPANY, LTD., and UNIVERSAL GAS & OIL COMPANY, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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The Petitioner respectfully prays that a Writ of Certiorari issue to review the Opinion and Judgment of the United States Court of Appeals for the Second Circuit entered in these proceedings on September 8, 1977.

A Petition bearing docket number 77-897 filed on December 22, 1977 by Messrs. Brener and Y. Meridor, other defendants-appellees below, seeks the same relief as is sought in this petition and raises some, but not all, of the questions presented herein.

OPINIONS BELOW

The Opinion of the Court of Appeals reversing the decision of the District Court and remanding the case is reported at ____ F.2d ____ (2d Cir. 1977) and is printed in the Appendix hereto (la *et seq.*). The Opinion of the District Court and Correcting Memorandum dismissing the Amended Complaint is reported at 426 F. Supp. 1059 (S.D.N.Y. 1977) and is printed in the Appendix hereto (35a *et seq.*).

JURISDICTION

The Judgment of the Court of Appeals was entered on September 8, 1977. A timely Petition for Rehearing was denied on October 21, 1977 (46a), and this Petition for a Writ of Certiorari was filed within 90 days of that date. The jurisdiction of the Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

A minority stockholder ("Goldberg") of a Panamanian corporation ("UGO") instituted a derivative action against all of the directors of UGO and its Panamanian parent ("MARITIMECOR"), alleging their knowing authorization of and participation in various unfair and wasteful transactions, including an unconsummated agreement by UGO to issue an undetermined number of its shares to MARITIMECOR in exchange for all of MARITIMECOR's assets and liabilities. No stockholder approval of these transactions was needed or sought. Although the gravamen of Goldberg's claim in his original and amended complaints was common law breach of fiduciary duty and unfairness, in order to avoid New York State's security-for-costs statute (BCL § 627), the Amended Complaint purportedly abandoned non-federal claims and asserted federal

jurisdiction under Section 10(b) of the Securities Exchange Act of 1934. It sought an injunction, damages and other relief. Goldberg's Amended Complaint did not allege any material/causal deception, or that he was a purchaser or seller of securities. However, on defendants' motion to dismiss the Amended Complaint for failure to state a claim, Goldberg offered to further amend his pleadings to allege that UGO's minority shareholders had been misled by inadequate disclosure. The motion to dismiss was granted and leave to again amend was denied.

1. In the foregoing context, are the purchaser-seller and material/causal deception requirements of Section 10(b) satisfied by either of the following allegations:

(a) That, had sufficient disclosure been made to UGO's minority shareholders of the agreement between UGO and its parent, those minority shareholders could have obtained a New York State injunction against consummation of the agreement;

(b) That, had sufficient disclosure been made, a fictional, independent Board of Directors, composed of reasonable men, would not have authorized the agreement between UGO and its parent, although the agreement was, in fact, authorized by UGO's real Board of Directors, who had full knowledge of the facts.

2. In the foregoing context, is it an abuse of discretion for a District Court, by denying leave to further amend a complaint, to decline to hear a complaint which, at best, after amendment, would involve only a "marginal" federal interest, and in which important issues of non-federal law would first have to be determined as a prelude to granting federal relief?

3. Do 28 U.S.C. § 1652 (State Laws as Rules of Decision in U.S. Courts) and/or this Court's decisions

make state security for costs and expenses statutes applicable to cases brought under the "federal common law" of Section 10(b)?

4. In this derivative action, instituted by a Floridian stockholder of a Panamanian corporation in a New York Federal Court, alleging a violation of Section 10(b) by means of an unfair transaction between a Panamanian corporation and its Panamanian parent, do federal choice of law rules require that Panamanian law be applied to determine whether a minority stockholder may sue derivatively?

STATUTES AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5; Section 9(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(e); Section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a); 28 U.S.C. § 1652, and New York Business Corporation Law (BCL) § 627 are set forth in the Appendix hereto (47a *et seq.*).

STATEMENT OF THE CASE

This is a minority stockholders' derivative action instituted by David Goldberg, a Floridian, in the United States District Court for the Southern District of New York on behalf of Universal Gas & Oil Company, Inc. ("UGO"), a Panamanian corporation. The original Complaint sought an injunction, damages and other relief against UGO's controlling parent, Maritimecor, S.A. ("MARITIMECOR"), also a Panamanian corporation, MARITIMECOR's own parent, Maritime Fruit Carriers Company, Ltd., an Israeli corporation, and all of UGO's directors and officers, most of whom are citizens and residents of countries other than the United States.

The original Complaint charged that the defendants, including all of UGO's directors, caused UGO to enter into transactions which had no business purpose, were of no benefit to UGO, represented self dealing, and constituted breaches of fiduciary duty owed to UGO. It was further alleged that the wrongful actions culminated in an agreement by which UGO was to issue to its parent MARITIMECOR not more than 4,200,000 shares of UGO's common stock in exchange for all of MARITIMECOR's assets and liabilities, except for certain UGO shares already owned by MARITIMECOR ("MARITIMECOR/UGO transaction"). According to Goldberg, the foregoing constituted a violation of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 issued pursuant thereto, as well as a violation of Common Law.

Pursuant to New York Business Corporation Law (BCL) § 627, UGO, the nominal defendant, moved that Goldberg be required to post adequate security for costs and expenses, or have his Complaint dismissed. The District Court granted this motion, unless Goldberg either amended his Complaint to eliminate all non-federal claims, or established that he was exempt from posting such security. Goldberg, whom the District Court subsequently found could not post security (43a) amended his Complaint in an effort to avoid its dismissal. However, except for minor cosmetic changes intended to eliminate all direct references to non-federal law, and the addition of a host of other defendants, the Amended Complaint contained the same allegations as had the original Complaint, all of which Goldberg now alleged constituted violations of Section 10(b).

Since the Amended Complaint contained no meaningful allegations of deception, materiality, or causation, the majority of the defendants, joined by UGO, filed motions to dismiss for failure to state a claim.

In opposition to the motion, Goldberg insisted that deception was not necessary. Alternatively, Goldberg's counsel sought leave to further amend the Amended Complaint to allege that there had been deception of the minority shareholders. Specifically, he asserted that two press releases issued by UGO describing the MARITIMECOR/UGO transaction constituted inadequate disclosure because they failed to disclose (a) facts which indicated that the MARITIMECOR/UGO transaction would be unfair to UGO; and (b) the conflict of interest between UGO and MARITIMECOR.

Concluding that deception was and had always been an indispensable element of a Section 10(b) claim, the District Court, Lasker, J., granted the motions to dismiss the Amended Complaint. He also denied leave to amend on the grounds that

> "[t]here is a limit to the time and energy a federal court should accord to marginal federal causes of action which are fully capable of being vindicated in state court. Presumably, if the element of deceit formed any significant aspect of Goldberg's claim, or was responsible for the alleged injury to UGO, Goldberg could have been expected to have plead such facts before the third go-round." (43a-44a)

Judge Lasker subsequently issued a "Correcting Memorandum" pointing out that the Supreme Court's recent decision in *Sante Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977) supported his earlier decision.

In apparent confirmation of Judge Lasker's view that his claim was essentially a state law claim, Goldberg subsequently brought an action in New York State Supreme Court, which is still pending. The complaint therein makes substantially the same allegations as those contained in this case.

Nevertheless, the Court of Appeals for the Second Circuit, in a panel composed of Judges Friendly, Timbers

and Meskill, *reversed,* finding that the court below should have given Goldberg a further opportunity to amend his pleadings. The majority also found that the Amended Complaint could be satisfactorily amended to include causal/material deception of UGO, by alleging insufficient disclosure to its minority stockholders of the MARITIMECOR/UGO agreement, although all the directors of UGO allegedly knew and participated in the acts complained of, and although no stockholders' approval of the MARITIMECOR/UGO transaction was required or sought.

The majority reasoned that if full disclosure of the allegedly unfair terms of the MARITIMECOR/UGO transaction had been made to UGO's minority stockholders, such stockholders could have instituted a derivative action in New York State court and obtained an injunction to stop consummation of the transaction.

The majority further reasoned that if full disclosure had been made, a fictional, independent UGO Board of Directors, composed of reasonable men, would have refused to authorize the MARITIMECOR/UGO agreement, although UGO's real board did do so.

Dissenting in part, Judge Meskill stated that the decision of the majority was in conflict with this Court's recent decisions in *Sante Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977); *Piper* v. *Chris-Craft Industries, Inc.,* 97 S. Ct. 926 (1977); and *Cort* v. *Ash,* 422 U.S. 66 (1975). He noted that under the majority's reasoning a cause of action under Section 10(b) would arise whenever controlling shareholders or directors failed to disclose their breach of fiduciary duty and a security was in some way involved. He further asserted that it was improper to premise a federal cause of action upon the availability of a hypothetical New York injunction, especially when it was unclear as to whether such an injunction was, in fact, available and when difficult choice of law issues were present. Moreover, he was concerned that the existence

of federal rights would depend on venue and non-federal law, since the courts of some jurisdictions might grant an injunction while others would not. In these circumstances, Judge Meskill asserted that the plaintiff be left to the State courts in which he already had a suit pending.

REASONS FOR GRANTING THE WRIT

QUESTION 1

THE DECISION BELOW CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT

With respect to the requirement of deception, the Second Circuit's decision is in conflict with this Court's teaching in *Santa Fe Industries, Inc.* v. *Green,* 430 U. S. 462 (1977). If permitted to stand, the circuit court's decision will open the doors of the federal courts to substantially all corporate mismanagement cases in which a security is somehow involved. This would be in direct violation of the spirit, if not the letter, of *Santa Fe.*

If "deception" is construed, as the court below has construed it, to include a deception which might affect hypothetical directors, or which might influence minority stockholders to seek hypothetical injunctions which they have not sought and which are not available in the real world, then the deception requirement of *Santa Fe* will have no practical meaning.

As pointed out by the dissenting opinion in the court below, if failure to disclose to minority shareholders the unfairness of a transaction or possible breaches of fiduciary duty can convert a non-federal common law claim into a federal one under Section 10(b), then this court's admonitions that Section 10(b) is not designed to create a national law of corporations will have to be retracted.

The decision below is also in conflict with the purchaser-seller requirements laid down by this Court in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U. S. 723 (1975).

Goldberg was neither a purchaser nor a seller of the securities involved here. Neither he nor any minority stockholder of UGO had any investment decision to make. The law of Panama, which was the place of incorporation of both UGO and MARITIMECOR, did not require shareholder approval of either the agreement which is attacked, or its consummation. Only UGO and its parent MARITIMECOR were seller and purchaser and only their respective boards of directors had to make investment decisions.

The decision below is in conflict with the decision in *Blue Chip Stamps* for yet another reason. In that case this Court found that an allegation of deception leading to *in*activity did not satisfy the pleading requirements of Section 10(b). In this case, however, the majority of the court below found sufficient a claim that UGO's minority shareholders were lulled into not seeking and obtaining a New York State court injunction because of an alleged deception. If an allegation of deception leading to inactivity in the purchase or sale of stock is insufficient, so too is pleading inactivity in seeking and obtaining an injunction. Both of these allegations involve "issues of fact" which are difficult to prove or disprove, thereby increasing the risk of "strike" suits, something which this Court condemned in *Blue Chip Stamps, supra.*

The foregoing issues have been dealt with more extensively in the petition filed under docket no. 77-897 by Messrs. Meridor and Brener, co-defendants-appellees in the action below, and the petitioner herein respectfully refers the Court to that petition for further exposition of the foregoing points.

QUESTION 2

A. THE COURT BELOW DECIDED AN IMPORTANT QUESTION OF STATE LAW IN A MANNER INCONSISTENT WITH THE DECISIONS OF THE HIGHEST COURT OF THE STATE OF NEW YORK

B. THE DECISIONS BELOW PRESENT AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE SETTLED BY THIS COURT, TO WIT: MAY A DISTRICT COURT DECLINE TO HEAR A COMPLAINT WHEN IT IS COUCHED IN THE LANGUAGE OF §10(b) BUT IS ESSENTIALLY A NON-FEDERAL CLAIM

Viewed from one perspective both the District Court and Judge Meskill recognized that it might be possible for Goldberg to plead a "slight" or "marginal" federal cause of action. Even so, both felt that it would be more appropriate for the federal court to stay its hand and to allow the appropriate state court to deal with this case, particularly since Goldberg had an action parallelling the instant one pending in New York State Court. In reversing Judge Lasker, the majority below apparently held that, so long as a federal cause of action could be "stated", the case could not be dismissed. In taking this mechanistic view, the Second Circuit paid insufficient attention to the doctrine of "abstention" recognized by this Court.

Abstention in favor of State Court proceedings may be proper even if federal jurisdiction is premised on a "federal" question. *See, Burford* v. *Sun Oil Company,* 319 U.S. 315 (1943); *Alabama Public Service Commission* v. *Southern Railway,* 341 U.S. 341 (1951). The scope of discretion in deciding whether to hear "federal" claims should be even greater in Section 10(b) actions, since such actions are, by their very nature, creatures of judicial implication and policy considerations. *See, Blue Chip Stamps* and *Santa Fe, supra.* The particular facts of this case present an ideal opportunity for this Court to settle the question of whether a federal court has discretion to decline to hear a claim asserted under Section 10(b), if it appears that such claim is best left to the state courts. See, Part IV of *Santa Fe, supra.*

In foreclosing Goldberg's right to re-amend his Complaint, Judge Lasker not only decided that the Complaint, as first amended, failed to state a federal cause of action, but also held that this case did not properly belong in a federal court, no matter how artfully re-pleaded.* Ironically, the grounds used by the Second Circuit to reverse Judge Lasker confirm his view of the case, since even that Court could only find a "federal" claim by resort to New York's law of injunctions.

Predicating a Section 10(b) claim upon the alleged loss of a state court injunction involves the federal judiciary in an improper investigation into the psychology of a hypothetical state court. It is an area from which a federal court should properly abstain. In addition to deciding whether an injunction is available as a matter of state choice of law rules and substantive law, the court must also indulge in speculation as to whether, under the facts of a particular case, a state court judge using his equitable discretion would have granted injunctive relief. In addition, the federal court is called upon to speculate as to the amount of a bond that a state court would have imposed upon the person seeking such an injunction, as well as to whether such person would have been able to actually post such a bond. Moreover, in a derivative action such as this one, the court must further engage in conjecture as to whether a representative stockholder would have been able to satisfy applicable state security-for-costs provisions.** Finally, the court would

*Judge Lasker recognized that the existence of federal rights should not depend upon the semantic versatility of a plaintiff's counsel. Use of the term "fraudulent" in place of "unfair" should not convert a common law claim into one under Section 10(b) (41a-42a). The accuracy of this observation was highlighted when the majority of the Second Circuit, in a subsequent order, modified its original opinion by substituting the words "a fraudulent" for the words "an unfair" (46a).

**In this case this was not speculation, since the District Court found that Goldberg could not do so (43a), a finding not controverted by the Court of Appeals majority.

have to speculate about how a state court might consider other equitable factors such as laches.*

The Second Circuit's decision not to abstain in this case is unsound for yet another reason—it's holding is in direct contradiction to existing New York law. Whatever the availability of injunctive relief in cases involving domestic New York corporations (see Footnote 7 of the opinion of Meskill, J. (30a)), New York law is clear that New York courts will not issue injunctions, and will not even take jurisdiction, in cases involving the "internal affairs" of a foreign corporation, even if that corporation has a substantial presence in New York. *See, Sternfeld* v. *Toxaway Tanning Co.*, 290 N.Y. 294, 49 N.E.2d 145 (1943); *Langfelder* v. *Universal Laboratories, Inc.*, 293 N.Y. 200, 56 N.E.2d 550 (1944); *Greenspun* v. *Lindley*, 44 A.D.2d 20, 352 N.Y.S.2d 633 (1st Dep't 1974), *aff'd*, 36 N.Y.2d 473, 330 N.E.2d 79, 369 N.Y.S.2d 123 (1975). Given the weight that opinions of the Second Circuit have in New York State courts (not to mention the controlling nature of their decisions on District Courts in New York State), its incorrect holding that an injunction was available under New York law in this case creates a wholly unnecessary confusion as to the status of New York State law, as regards both its choice of law rules and its law of injunctions. Accordingly, that holding should not be allowed to stand.

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*In this case this too did not require speculation, since Goldberg is obviously guilty of laches, having thus far failed to seek his "lost" injunction in state court, although he has an action pending there and although UGO has yet to issue any stock to its parent.

QUESTION 3

THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE SETTLED BY THIS COURT, TO WIT: THE EXTENT TO WHICH STATE LAW (IN PARTICULAR STATE SECURITY-FOR-COSTS PROVISIONS) IS APPLICABLE TO CASES BROUGHT UNDER SECTION 10(b)

The District Court found that Goldberg could not satisfy BCL § 627, which requires a minority stockholder like Goldberg, suing derivatively, to post security for costs and expenses (49a-50a), a finding that has never been challenged. Accordingly, if BCL § 627 is applicable to "federal common law" cases such as this one, then Goldberg's complaint was properly dismissed, however he might have amended it.

This Court has never ruled on whether relevant state security-for-costs provisions are applicable to derivative actions brought under Section 10(b), which, as creatures of judicial implication, are prime examples of "federal common law". While in *McClure* v. *Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961) the Third Circuit asserted that such state provisions did not apply, that decision is incompatible with this Court's decision in *Wallis* v. *Pan American Petroleum Corp.*, 384 U.S. 63 (1966) some five years later. In *Wallis* this Court held that, unless application of state law posed a "significant threat" to federal policy, "federal common law" divergent from state law should not be adopted. The decision in *McClure* is also inconsistent with the more recent holding in *United States* v. *Little Lake Misere Land Company*, 412 U.S. 580 (1973), in which this Court held that, in forming federal common law, the federal courts would "borrow" state law, especially if such state law "served legitimate and important state interests", unless such state law was "plainly hostile" to federal interests.

State security-for-costs provisions are designed to prevent "strike" suits. This Court has recognized that the threat of "strike" suits is particularly real in Section 10(b) actions, and is not desirable. Elimination of "strike" suits is one consideration in drawing the parameters of the judicially implied cause of action under Section 10(b). *See, Blue Chip Stamps, supra.* Thus, not only is the policy underlying BCL § 627 not hostile to federal policy, but the legislative policy of New York State is in accord with one espoused by this Court. Applying BCL § 627 to the "federal" claims asserted by Goldberg in the Amended Complaint would, therefore, pose no "significant threat" to federal policy. Moreover, other sections of the Securities Exchange Act of 1934 expressly provide for security for *defendant's* costs. *See* Sections 9(e) and 18(a) thereof (48a-49a). If security for defendant's costs is part of express federal policy, then *a fortiori* security for the costs of UGO, the real *plaintiff*, cannot be contrary to federal public policy.

To a significant extent, the attempts of plaintiffs in derivative actions to fit the "square peg" of a state law claim into the "round hole" of Section 10(b) (of which this case is a prime example) are motivated by a desire to avoid state security-for-costs provisions. In such cases, a federal forum has been chosen not because a "federal" right is being vindicated, but because, tactically speaking, a federal forum is desirable since it supposedly has no security-for-costs provisions.* Forum shopping of this kind is just as damaging to the integrity of the judicial system as that condemned by this Court in *Erie Railroad Co.* v. *Tompkins,* 304 U.S. 64 (1938). Moreover, the waste of federal judicial resources in dealing with such pseudo-federal claims is thoroughly unjustified. There is no reason why revelant state security-for-costs provisions

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**See,* Jennings and Marsh, *Securities Regulation,* (3d. ed.) at p. 1223.

should not be applied in different federal forums, just as different state statutes of limitations are applied in the federal courts in Section 10(b) cases. *See, Charney* v. *Thomas,* 372 F.2d 97 (7th Cir. 1967). In such event, derivative plaintiffs will not seek to seduce the federal courts into taking their cases through ever more imaginative theories and pleadings.

In addition to this Court's holdings in *Wallis* and *Little Lake, supra*, 28 U.S.C. § 1652 mandates that

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

There is nothing in the Securities Exchange Act of 1934, or its legislative history, which indicates that Congress meant to exempt cases brought under that Act from state security-for-costs laws. On the contrary, as noted above, Federal and State policies in this area are in substantial accord.

QUESTION 4

THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE SETTLED BY THIS COURT, TO WIT: SHOULD FOREIGN LAW BE APPLIED TO SECTION 10(b) CASES OF INTERNATIONAL DIMENSIONS

The Court of Appeals impliedly recognized that a choice of law issue was presented in this case; *i.e.*, whether Panamanian law applies and whether that law denies Goldberg standing to sue derivatively on UGO's behalf. The majority suggested that it might have decided the case differently had it been shown that Goldberg's derivative mode of action was unavailable

under Panamanian law, citing to its decision in *Hausman* v. *Buckley*, 299 F.2d 696 (2d Cir. 1969), *cert. denied*, 369 U.S. 885 (1962) (23a). Although the petitioner and others addressed themselves to these questions in their petition for rehearing, the Second Circuit nevertheless declined to grant a rehearing (Meskill, J. dissenting (46a)).

Under federal choice of law rules, Panamanian law applies. The parties to the transactions complained of by Goldberg are two Panamanian corporations. Accordingly, Panama has the paramount interest in this case, and its law should be applied to this matter. *See*, *Lauritzen* v. *Larsen*, 345 U.S. 571 (1952). In addition, this transaction, involving as it does the "internal affairs" of Panamanian corporations, is governed by the law of Panama. *See*, *Shaffer* v. *Heitner*, 97 S.Ct. 2569, 2586 at n.44 (1977). Under law Number 9 of the Republic of Panama, the derivative mode of action is unknown; consequently, Goldberg's claim would have to be dismissed. This result is not contrary to public policy. *See*, *Hausman* v. *Buckley*, *supra*.

CONCLUSION

As the discussion above indicates, the decision of the Second Circuit is incompatible with several decisions of this Court. In addition, the holding of the Court of Appeals is in direct conflict with the law of the State of New York, which law formed the principle basis for the Second Circuit's decision. Moreover, the issues in this case which involve forum shopping, as well as the applicability of 28 U.S.C. § 1652 to "federal common law", pose important and complex questions of federal law which demand the attention of this Court. Finally, by refusing to give heed to applicable federal choice of law rules and by failing to give due recognition to the applicability of the doctrine of "abstention" to the facts of this case, the Second Circuit erred and should be reversed by this Court.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 1289—September Term, 1976.
(Argued June 9, 1977 Decided September 8, 1977.)
Docket No. 77-7146

DAVID GOLDBERG, suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC.,

Plaintiff-Appellant,

v.

YAACOV MERIDOR, MILA BRENER, DAVID MERIDOR, S. ERELL, GIDEON BEN AARON, ARA A. CAMBERE, H. STRUVE HENSEL, HAIM RAFAELI, MARTIN SIEM, JACOB SUTTON, HENRY A. SINGER, MARITIMECOR, S.A., MARITIME FRUIT CARRIERS COMPANY, LTD., HORNBLOWER & WEEKS, HEMPHILL NOYES, INC., LAVENTHOL & HORWATH a/k/a LAVENTHOL KREKSTEIN, HORWATH & HORWATH, DR. JACOBO DAMM, DR. MAX LEBEDKIN, ELIE HOUSMAN, H. L. FEDERMAN, WILLIAM J. FRIEDMAN, MERRIL M. HALPERN, PER HY-SING-DAHL, ANDRE MONTELL, FRITZ KONIG, ZEV LEVIN, RAYMOND CALIEZI,

Defendants-Appellees,

and

UNIVERSAL GAS & OIL COMPANY, INC.,

Nominal Defendant.

Before:

FRIENDLY, TIMBERS and MESKILL,

Circuit Judges.

Opinion of Henry J. Friendly, C.J.

FRIENDLY, *Circuit Judge:*

In this derivative action in the District Court for the Southern District of New York, David Goldberg, a stockholder of Universal Gas & Oil Company, Inc. (UGO), a Panama corporation having its principal place of business in New York City, sought to recover damages and to obtain other relief against UGO's controlling parent, Maritimecor, S.A., also a Panama corporation; Maritimecor's controlling parent, Maritime Fruit Carriers Company Ltd., an Israel corporation; a number of individuals who were directors of one or more of these companies; the investment firm of Hornblower & Weeks, Hemphill, Noyes, Inc.; and the accounting firm of Laventhol & Horwath, with respect to transactions which culminated in an agreement providing for UGO's issuance to Maritimecor of up to 4,200,000 shares of UGO stock and its assumption of all of Maritimecor's liabilities (including a debt of $7,000,000 owed to UGO) in consideration of the transfer of all of Maritimecor's assets (except 2,800,000 UGO shares already held by Martitimecor). It suffices at this point to say that the complaint, filed February 3, 1976, alleged that the contract was grossly unfair to UGO and violated both § 10(b) of the Securities Exchange Act and the SEC's Rule 10b-5 and common law fiduciary duties. By notice of motion filed June 2, 1976, the nominal defendants UGO moved for a stay pending plaintiff's posting security for expenses and costs under § 627 of the N.Y. Business Corporation Law. By order filed July 30, 1976, the district court ruled that following receipt of UGO's shareholder list, Goldberg was required either to meet the exemptions from posting security under § 627, post the security otherwise required in an amount to be determined, or "amend his complaint in this action to eliminate any and all claims based on or arising out of state common law or state statutory law."

Goldberg chose the latter course. The amended complaint, filed August 27, 1976, which was largely repetitive of the original complaint save for the omission of reference to state law claims, made the following principal allegations: The defendants engaged in "a conspiracy or plan" "to cause UGO to raise funds from the public by a public offering and then by various transactions hereafter set forth, including the transfer of UGO stock to Maritimecor for the latter's assets and liabilities, use the proceeds of the offering and the assets of UGO for the benefit of defendants Maritimecor and Maritime Fruit." In May 1972 defendants caused UGO to issue a prospectus offering for sale 11,000 units consisting of 363,000 shares of common stock and $11,000,000 worth of 8% convertible debentures. The prospectus stated that all the proceeds of the offering would be used to finance the construction and purchase of three tankers for the transportation of liquified gas and that UGO's business would be the transportation of such gas. In 1974 defendants caused UGO to sell the contracts for two of the vessels, for a total price of $25,000,000 of which $14,000,000 was profit. During 1974 and up to August 1975, defendants caused UGO to make loans to Maritimecor so that $7,000,000 was owed by the latter. In August 1975 defendants caused UGO to enter into the agreement described in the first paragraph of this opinion, which was later carried out at least to the extent of the transfer of Maritimecor's assets and liabilities to UGO. The "agreement and transfer was frudulent and unfair in that the assets of Maritimecor were overpriced and of insufficient value, the liabilities of Maritimecor either exceeded the value of its assets or were so great that the net asset value was insufficient consideration, the liabilities included a $7,000,000 debt to UGO from Maritimecor, and the purpose and intent of said transaction was to cause the dissipa-

tion of the substantial assets of UGO for the benefit of defendants, Maritimecor and Martime Fruit. [T]he defendants . . . knew at the time, or had reasonable cause to know and were negligent in not ascertaining that the agreement and transfer were a fraud and unfair to UGO, and that the net value of the assets of Maritimecor was far less than the value of the shares of UGO to be issued to Maritimecor, or that Maritimecor's liabilities exceeded its assets." Then came paragraph 19, which alleged as follows:

> The issuance of the aforesaid prospectus and the foregoing transactions constituted the employment of a device, scheme or artifice to defraud, the making of untrue statements of material fact and the omission to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and the engaging in acts, practices, and courses of conduct which operated as a fraud or deceit upon UGO as the seller of up to 4,200,000 shares of UGO's common stock for Maritimecor's liabilities and assets, and upon UGO's minority stockholders.

Defendants filed motions to dismiss the amended complaint for failure to state a claim under § 10(b) of the Securities Exchange Act and Rule 10b-5. In answer to defendants' argument "that deception and non-disclosure is a requirement for a 10b-5 case" which was disputed as a matter of law, plaintiff's counsel submitted an affidavit asserting that "insofar as plaintiff Goldberg, a minority shareholder is concerned, there has been no disclosure to him of the fraudulent nature of the transfer of Maritimecor assets and liabilities for stock of UGO". Counsel annexed two press releases dated August 1 and December 19, 1975,

which described the agreement for and the consummation of the UGO-Maritimecor transaction. Counsel asserted that these press releases failed to disclose the facts noted in the margin[1] or "the conflicts of interest of the principals".[2] Counsel requested that he given leave to replead should the court find any defect in the manner of pleading. In a further affidavit addressed to the question of damage, counsel averred that at the end of 1974 UGO had current assets of about $41 million and current liabilities of $2 million but that after the transfer Maritimecor's net current liabilities of $42.5 million caused UGO to wind up with a deficit of about $3.6 million of current liabilities. He also alleged that as a result of the transaction UGO had defaulted in its obligations and its ships were being seized by creditors.

On February 11, 1977, Judge Lasker filed an opinion, 426 F. Supp. 1059, that granted the motions to dismiss. He

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[1]Maritimecor, as of the end of fiscal year 1974 had current liabilities of $42.5 million dollars, and in addition Maritimecor owed UGO about $7 million dollars which apparently was being forgiven in the transaction. The shareholders' net equity in Maritimecor was $40.4 million dollars or substantially less than its current liabilities. Further, included in the assets of Maritimecor are 2.8 million shares of UGO, the value of which are substantially decreased as a result of this transaction.

[2]In fact both press releases did state that Maritimecor was UGO's "parent" and the first recounted that on consummation of the transaction Maritimecor ownership of UGO common stock "will increase from 2,800,000 (78 percent) to 7,000,000 (90 percent)" while "[a]n additional 500,000 shares and 289,100 shares of UGO common stock are now held—and will continue to be held—by a subsidiary of Panmaritime Limited S.A., a Panama corporation which controls [Maritime Fruit], and the public, respectively."

Both releases also concluded with a statement that "UGO's common stock and 8 percent Convertible Subordinated Debentures are traded over-the-counter (NASDAQ-UGOLF and UGOLZ, respectively)."

thought the case was governed by *Popkin v. Bishop,* 464 F.2d 714 (2 Cir. 1972), rather than by our *en banc* decisions in *Schoenbaum* v. *Firstbrook,* 405 F.2d 215 (2 Cir. 1968), *cert. denied,* 395 U.S. 906 (1969), and *Drachman* v. *Harvey,* 453 F.2d 722 (2 Cir. 1972), and held that *Marshel* v. *AFW Fabric Corp.,* 533 F.2d 1277 (2 Cir.), *vacated and remanded for consideraion of mootness,* 429 U.S. 881 (1976), and *Green* v. *Santa Fe Industries, Inc.,* 533 F.2d 1283 (2 Cir.), which was pending before the Supreme Court on grant of certiorari, 429 U.S. 814 (1976), were limited to the situation of "going private". He denied leave to amend as hereafter discussed. After the reversal of *Green,* —— U.S.——(1977), 45 L.W. 4317, the judge filed a memorandum adding to the opinion fn.4 to the effect that the Supreme Court's decision rendered his analysis of our decision moot but lent subsantial support to the result.

I.

Before proceeding further, we must deal with the district court's refusal to permit amendment of the complaint to include reference to the two press releases or otherwise to claim deception. The judge's explanation of this was as follows, 426 F. Supp. at 1064:

> There have already been two complaints. . . . Both are prime examples of an attempt to fit the square peg of a state law claim into the round hold of a 10b-5 allegation. When the original complaint was dismissed for failure to post security or obtain the requisite support from other minority shareholders, Goldberg was made exquisitely aware of the need to limit this amended pleading to a federal claim, unless he could post security under state law, which he could not.

> Although he now contends that he could allege that [he] was deceived by the defendants with regard to the terms of the transaction with Maritimecor, he chose to frame the amended complaint in such a way as to exclude this element altogether. There is a limit to the time and energy a federal court should accord to marginal federal causes of action which are fully capable of being vindicated in state court. Presumably, if the element of deceit formed any significant aspect of Goldberg's claim, or was responsible for the alleged injury to UGO, Goldberg could have been expected to have plead such facts before the third go-around.

The third sentence conveys a rather misleading impression as to the court's earlier ruling. The court had offered Goldberg a choice between complying with New York Business Corporation Law § 627 or dropping any reference to state claims. When Goldberg chose to do the latter, nothing had yet been said by the defendants or the judge concerning the alleged inadequacy of his pleading of the federal claim. Goldberg had indeed been made "exquisitely aware" that he must drop his state claim if he wished to avoid compliance with § 627 of the New York Corporation Law, but not at all that he had failed to plead a federal claim through insufficient reference to deception. In every real sense when Goldberg requested further leave to amend he thus was seeking a second round, not a third. If Goldberg's counsel had been earlier made aware of the alleged deficiency in his complaint, it would have been easy for him to include in his first amended complaint reference to the press releases and the contrast between their complacent tone and the grim actualities asserted in counsel's affidavit on damage and also to include the fact, which had already

surfaced in discovery, that one of UGO's directors, Martin Siem, claimed that he had been deceived or at least had not been fully informed with regard to the Maritimecor transaction. When counsel requested leave to replead, no answers had yet been filed. Contrast *Browning Debenture Holders' Committee* v. *DASA Corp.*, slip op. 5219, 5231-36 (2 Cir., decided August 11, 1977). The considerations explicated in *Schoenbaum, supra*, 405 F.2d at 218, as to the undesirability of granting summary judgment to defendants in a stockholder's derivative suit before discovery has been completed, see also 6 *J. Moore, Federal Practice* ¶ 56.17[60], at 56-1065 (1976 ed.), dictate liberality in allowing such complaints to be amended to reflect facts already discovered. We are therefore constrained to hold that the refusal of leave to amend was an abuse of discretion and to treat the cases as if an amendment, at least in the two respects noted, had been allowed.

II.

If the complaint were thus amended, we would deem it clear that, so far as this court's decisions are concerned, the case would be governed by *Schoenbaum* rather than by *Popkin*.[3] The August 1 press release held out an inviting picture that

> As a result of the transaction, UGO will replace Maritimecor as the principal operating subsidiary of MFC

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[3]We do not mean this to imply agreement with the district court's contrary conclusion with respect to the first amended complaint. It is simply unnecessary to decide this.

Plaintiff does not contend that the allegations with respect to the May 1972 prospectus are sufficient to support the complaint; any injury from misleading statements in the prospectus would be to the purchasers, not to the corporation on whose behalf this action was brought.

> and, as such, will engage in a diversified line of shipping and shipping related activities including the sale of ships and ship-building contracts, the operation of reefers and tankers, and upon their delivery, product carriers and oil drilling rigs, and underwriting marine insurance.[4]

when allegedly the truth was that UGO had entered into a transaction that would ensure its doom. *Popkin* was specifically rested on its special facts. The plaintiff was taken to have conceded that the complaint did not allege misrepresentation or non-disclosure and that he relied solely on the unfairness of the merger terms, see 464 F.2d at 718 & n.9, 720. The opinion expressly noted that "[u]nquestionably this court has recognized that the Rule 10b-5 reaches beyond traditional stock transactions and into the board rooms of corporations" and that "assertions by a defendant that the misconduct complained of 'really' amounts to 'just' corporate mismanagement will not cut off a plaintiff's federal remedy." 464 F.2d at 718. The court likewise quoted with approval, 464 F.2d at 719, Judge Hays' statement in dissenting from the panel opinion in *Schoenbaum,*

> In order to establish fraud it is surely not necessary to show that the directors deceived themselves. It must be enough to show that they deceived the shareholders, the real owners of the property with which the directors were dealing. Deception of the shareholders (with the exception of the majority stockholder which was a party to the transactions) is established by showing that the directors withheld from them information that would have revealed the true value of the treasury stock.

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[4]The December 19 press release contained a similar statement.

and the statement in his opinion for the *en banc* court in that case,

> Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine). (Footnote omitted.)

The observation in *Popkin*, 464 F.2d at 719, that "our emphasis on improper self-dealing did not eliminate non-disclosure as a key issue in the Rule 10b-5 cases" followed a statement that when, as here, state law does not demand prior shareholder approval of a transaction, "it makes sense to concentrate on the impropriety of the conduct itself rather than on the 'failure to disclose' it because full and fair disclosure in a real sense will rarely occur. It will be equally rare in the legal sense once the view is taken—as we did in *Schoenbaum*—that under federal securities law disclosure to interested insiders does not prevent a valid claim that fraud was committed upon 'outsiders' (such as minority shareholders) whatever the requirements of state corporate law may be." *Id.* The ruling of *Popkin* was that in the *opposite* situation, where "merger transactions . . ., under state law, must be subjected to shareholder approval . . . if federal law ensures that shareholder approval is fairly sought and freely given, the principal federal interest is at an end," 464 F.2d at 720, see also *id.* n.17. Clearly that is not this case. *Cf. Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579, 598 n.27 (5 Cir.), *cert. denied*, 419 U.S. 873 (1974).

III.

The ruling that this case is attracted by *Schoenbaum* rather than by *Popkin* by no means ends our inquiry. Rather it brings us to the serious question whether *Schoen-*

baum can be here applied consistently with the Supreme Court's decision in *Santa Fe Industries, Inc.* v. *Green, supra.* We think it can be and should.

Before we address ourselves directly to the *Green* opinion, it will be useful to review the development of the law on the application of § 10(b) and Rule 10b-5 to derivative actions. There can be no doubt that the Securities Exchange Act "protects corporations as well as individuals who are sellers of a security" and that it is irrelevant that "the transaction is not conducted through a securities exchange or an organized over-the-counter market." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 10-11 (1971). The Court there quoted with approval the language in *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195, 203 (5 Cir. 1960), *cert. denied,* 365 U.S. 814 (1961),

> Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero.

and made the oft-quoted pronouncement, 404 U.S. at 12, paraphrasing its earlier decision as to construction of the anti-fraud provision of the Investment Advisors Act of 1940, see *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 195 (1963), that

> Section 10(b) must be read flexibly, not technically and restrictively.

The problem with the application of § 10(b) and Rule 10b-5 to derivative actions has lain in the degree to which the knowledge of officers and directors must be attributed

to the corporation, thereby negating the element of deception. Our first important encounter with this problem was in *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2 Cir. 1964). We rejected the attribution, saying 339 F.2d at 29:

> We come then to the question whether it is possible within the meaning of Section 10(b) and Rule 10B-5 for a corporation to be defrauded by a majority of its directors. We note at the outset that in other contexts, such as embezzlement and conflict of interest, a majority or even the entire board of directors may be held to have defrauded their corporation. When it is practical as well as just to do so, the courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself.
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> If, in this case, the board defrauded the corporation into issuing shares either to its members or others, we can think of no reason to say that redress under Rule 10B-5 is precluded, though it would have been available had anyone else committed the fraud. There can be no more effective way to emasculate the policies of the federal securities laws then to deny relief solely because a fraud was committed by a director rather than by an outsider. Denial of relief on this basis would surely undercut the congressional determination to prevent the public distribution of worthless securities.

Although it was there claimed that certain directors withheld information from others, the above quoted passage indicated in dictum that not only the majority but even the entire board, fully informed, could be held to have defrauded the corporation if they all had an interest in a transaction adverse to it. Less than a month later, how-

ever, another panel declined to follow the *Ruckle* dictum. *O'Neil* v. *Maytag,* 339 F.2d 764, 767 (2 Cir. 1964).

The future, both in this circuit and in others, lay with the *Ruckle* dictum rather than with *O'Neil. Dasho* v. *Susquehanna Corp.,* 380 F.2d 262, 270 (7 Cir.) ("concurring" opinion), *cert. denied,* 389 U.S. 977 (1967), refused to "differentiate between situations where the directors were unanimous in wrongdoing and those where less than all were involved." In *Pappas* v. *Moss,* 393 F.2d 865, 869 (3 Cir. 1968), the court said in rejecting defendants' claim that "the corporation was not deceived" in issuing stock to insiders and others at a low price because "all of its agents (directors) here were aware of the true facts":

> if a "deception" is required in the present context, it is fairly found by viewing this fraud as though the "independent" stockholders were standing in the place of the defrauded corporate entity at the time the original resolution authorizing the stock sales was passed . . . . Certainly the deception of the independent stockholders is no less real because, "formalistically", the corporate entity was the victim of the fraud.

Dealing with the argument that there must be either affirmative misrepresentation to stockholders or the misleading of a minority of the directors, Judge Seitz wrote, 393 F.2d at 869-70:

> We think these references as to their position indicate that their construction of Rule 10b-5 is untenable. It exalts form over substance. Indeed, it seems to suggest that there is an inverse relationship between the application of the Rule and the number of directors participating in a fraud on its corporation. Finally, it restricts the application of the Rule in a way which is

> at odds with its basic purpose. See McClure v. Borne Chem. Co., 292 F.2d 824 (3rd Cir.), cert. denied, 368 U.S. 939 (1961).[5]

We cited *Pappas* with approval in the *en banc* opinion in *Schoenbaum,* 405 F.2d at 220,

> Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine). See Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

thereby effectively overruling any requirement of *O'Neil* that there must be one virtuous or ignorant lamb among the directors in order for liability to arise under § 10(b) or Rule 10b-5 on a deception theory as to securities transactions with a controlling stockholder.[6] See *Jennings &*

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[5]Although recognizing that *Pappas* considered deception of minority shareholders to be sufficient, defendants would distinguish the case on the ground of the existence of misrepresentations in the minutes of the directors' meeting authorizing the sale of the stock and in proxy material issued to obtain stockholder ratification which the court had found ineffective apart from this. See 393 F.2d at 870, 868. But this clearly was not the *ratio decidendi of Pappas.*

[6]Even the majority panel opinion in *Schoenbaum* recognized that, 405 F.2d at 211,

> knowledge of the corporation's officers and agents is not imputed to it when there is a conflict between the interests of the officers and agents and the interests of the corporate principal . . . . Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2). (Footnote omitted.)

though it thought that director knowledge did negate corporate deception "[s]ince the directors were all fully informed and since only the non-interested directors participated in the vote authorizing the sale", 405 F.2d at 212.

Marsh, Securities Regulation, 998-99 (1977). See also *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 865 n.1 (2 Cir. 1968) (Friendly, *J.*, concurring), *cert. denied,* 394 U.S. 976 (1969).

We followed *Schoenbaum* in *Drachman* v. *Harvey,* 453 F.2d 736 (2 Cir. 1972) (*en banc*), although in that case not all the directors were parties to the fraud, and in *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374 (2 Cir. 1974), *cert. denied,* 421 U.S. 976 (1975). *Schoenbaum* has been generally applauded by commentators, even though it may sometimes have been read to mean more than it does or than is needed to call for a reversal here. See, e.g., Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement,* 15 N.Y.L.F. 332 (1969) (making the perceptive suggestion that "it is inconceivable that a court which in *Texas Gulf Sulphur* [401 F.2d 833 (2 Cir. 1968), *cert. denied,* 394 U.S. 976 (1969)] emphasized the disclosure purposes of the Exchange Act could have reached any different result in *Schoenbaum*"); Folk, *Corporation Law Developments—1969,* 56 Va. L. Rev. 755, 805-12 (1970); Comment, Schoenbaum v. Firstbrook: *The "New Fraud" Expands Federal Corporation Law,* 55 Va. L. Rev. 1103 (1969); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases,* 86 Harv. L. Rev. 1007 (1973); Note, Schlick v. Penn-Dixie Cement Corp.: *Fraudulent Mismanagement Independent of Misrepresentation or Nondisclosure Violates Rule 10b-5,* 63 Calif. L. Rev. 563 (1975); 41 Ford. L. Rev. 742 (1973); see also Bahlman, *Rule 10b-5: The Case for its Full Acceptance as Federal Corporation Law,* 37 U. Cinn. L. Rev. 727, 735-36 (1968) (criticizing the panel opinion in *Schoenbaum*); but see Note, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity,* 74 Yale L.J. 658, 681-82

(1965); Comment, 47 N.Y.U. L. Rev. 1279 (1972). It likewise is viewed with approval—indeed seemingly would be adopted—by §§ 1303 and 1402(c) of the proposed ALI Federal Securities Code, Tent. Draft No. 2 (March 1973) and revised comments in Reporter's Revision of Text of Tentative Drafts Nos. 1-3, pp. 104-06 (Oct. 1, 1974), see also §§ 234D(c) and 1301. It has also found favor in other circuits. A notable instance is *Shell* v. *Hensley,* 430 F.2d 819, 827 (5 Cir. 1970), where the court in a derivative suit rejected a claim that no "causal deceit" existed when the corporation's board knew all the facts, saying:

> When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations, the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of the material information known to the other party to the transaction.[7]

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[7]See *Superintendent of Insurance, supra,* 404 U.S. at 12-13, where the Court quoted the *Shell* court's description of a situation thought to be indistinguishable from the one faced in *Shell:*

> The crux of the present case is that [the corporation] suffered an injury as a result of deceptive practices touching its sale of securities as an investor. As stated in *Shell* v. *Hensley,* 430 F.2d 819, 827:
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> > "When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability." (Footnote omitted.)

See also *Rekant* v. *Desser,* 425 F.2d 872, 879-82 (5 Cir. 1970); *Jannes* v. *Microwave Communications, Inc.,* 461 F.2d 525, 529 (7 Cir. 1972); *Bailey* v. *Meister Brau, Inc.,* 535 F.2d 982, 993 (7 Cir. 1976); 1 *Bromberg, Securities Law: Fraud* §§ 4.7 (544)-(545) (collecting cases and noting, at pp. 84.51-84.52 that "[m]ost courts have now modified their views of deception to accommodate . . . (1) informational deception of a non-decision-maker who has a role or economic interest (minority director, shareholder, or creditor) or (2) non-informational deception measured by economic injury (to the company of other parties with real economic interest) equivalent to that resulting from informational deception of decision makers").

Schoenbaum, then, can rest solidly on the now widely recognized ground that there is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction. Assuming that, in light of the decision in *Green,* the existence of "controlling influence" and "wholly inadequate consideration"—an aspect of the *Schoenbaum* decision that perhaps attracted more attention, see 405 F.2d at 219-20—can no longer alone form the basis for Rule 10b-5 liability, we do not read *Green* as ruling that no action lies under Rule 10b-5 when a controlling corporation causes a partly owned subsidiary to sell its securities to the parent in a fraudulent transaction and fails to make a disclosure or, as can be alleged here, makes a misleading disclosure. The Supreme Court noted in *Green* that the court of appeals "did not disturb the District Court's conclusion that the complaint did not

allege a material misrepresentation or nondisclosure with respect to the value of the stock" of Kirby; the Court's quarrel was with this court's holding that "neither misrepresentation nor nondisclosure was a necessary element of a Rule 10b-5 action", —— U.S. at ——, 45 L.W. at 4319, and that a breach of fiduciary duty would alone suffice, see fn. 8. It was because "the complaint failed to allege a material misrepresentation or material failure to disclose" that the Court found "inapposite the cases [including *Schoenbaum*] relied upon by respondents and the court below, in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception", —— U.S. at ——, 45 L.W. at 4320, see fn. 15. While appellant is wrong in saying that the Court "approved" these cases, there is no indication that the Court would have casually overturned such an impressive and unanimous body of decisions by courts of appeals. To the contrary, the Court used rather benign language about them, saying that they "forcefully reflect the principle that '[s]ection 10(b) must be read flexibly not restrictively' and that the statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities . . .," citing the *Superintendent of Insurance* case, *supra,* 404 U.S. at 12-13. Mr. Justice White simply distinguished these cases as not supporting the position we had taken in *Green,* namely, "that a breach of fiduciary duty by majority stockholders, *without any deception, misrepresentation, or nondisclosure,* violates the statute and the Rule." (Emphasis supplied.)

Here the complaint alleged "deceit . . . upon UGO's minority shareholders" and, if amendment had been allowed as it should have been, would have alleged misrepresenta-

tion as to the UGO-Maritimecor transaction at least in the sense of failure to state material facts "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," Rule 10b-5(b).[8] The nub of the matter is that the conduct attacked in *Green* did not violate the " 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure' ", —— U.S. at ——, 45 L.W. at 4321; the conduct here attacked does.

Defendants contend that even if all this is true, the failure to make a public disclosure or even the making of a misleading disclosure would have no effect, since no action by stockholders to approve the UGO-Maritimecor transaction was required. Along the same lines our brother Meskill, invoking the opinion in *Green*, —— U.S. at —— n.14, 45 L.W. at 4320 n.14, contends that the defendants' acts were not material since plaintiff has failed adequately to allege what would have been done had he known the truth.

In *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976), a case arising under Rule 14a-9, the Court laid down the standard of materiality as "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder" or, putting the matter in another way, "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered

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[8]We do not mean to suggest that § 10(b) or Rule 10b-5 requires insiders to characterize conflict of interest transactions with pejorative nouns or adjectives. However, if Maritimecor was in the parlous financial condition alleged in the opposing affidavit of plaintiff's counsel, a disclosure of the acquisition of Maritimecor that omitted these *facts* would be seriously misleading.

the 'total mix' of information made available." When, as in a derivative action, the deception is alleged to have been practiced on the corporation, even though all the directors were parties to it, the test must be whether the facts that were not disclosed or were misleadingly disclosed to the shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood" that such directors would have considered the "total mix" of information available to have been "significantly altered." That was the basis for liability in *Schoenbaum;* it was likely that a reasonable director of Banff, knowing the facts as to the oil discovery that had been withheld from minority shareholders, would not have voted to issue the shares to Aquitaine at a price below their true value. This also is the principle recognized in the passage from Judge Ainsworth's opinion in *Smith* v. *Hensley, supra,* 430 F.2d at 827, quoted above. Here there is surely a significant likelihood that if a reasonable director of UGO had known the facts alleged by plaintiff rather than the barebones of the press releases, he would not have voted for the transaction with Maritimecor.

Beyond this Goldberg and other minority shareholders would not have been without remedy if the alleged facts had been disclosed. The doubts entertained by our brother as to the existence of injunctive remedies in New York, see footnotes 7 and 9 and accompanying text, are unfounded. *Blumenthal* v. *Roosevelt Hotel, Inc.,* 202 Misc. 988, 115 N.Y.S.2d 52 (Sup. Ct. N.Y. Co. 1952), and *Williams* v. *Bartell,* 34 Misc. 2d 552, 226 N.Y.S.2d 187 (Sup. Ct. N.Y. Co.), *modified,* 16 App. Div. 2d 21, 225 N.Y.S.2d 351 (1st Dept. 1962), were suits by stockholders acting in their own behalf to enjoin the sale of all corporate assets or a merger transaction as to which

New York afforded dissenters the remedy of an appraisal. While the appraisal remedy was not exclusive, the existence of that remedy was held to require a plaintiff seeking an injunction to demonstrate a strong balance of equities in his favor. The UGO-Maritimecor transaction was not of the sort that would afford UGO's stockholders any right of appraisal. Where an appraisal remedy is not available, the courts of New York have displayed no hesistancy in granting injunctive relief, *see e.g., Robinson* v. *New York & P.C. R. Co.,* 123 App. Div. 339, 108 N.Y.S. 91 (1st Dept. 1908) (enjoining transfer of assets); *Levy* v. *Pacific Eastern Corp.,* 153 Misc. 488, 492, 275 N.Y.S. 291, 298 (Sup. Ct. N.Y. Co. 1934) ("As a court of equity will afford appropriate relief after the event, it will also act to prevent any threatened injury by the exercise of its plenary and exclusive jurisdiction over the trust relation."); *Silverman* v. *Lehrman,* 25 Misc.2d 339, 203 N.Y.S.2d 171 (Sup. Ct. Kings Co. 1960) (enjoining transaction between subsidiary and parent); *Rebell* v. *Muscat,* 26 App. Div.2d 685, 272 N.Y.S.2d 478 (2d Dept. 1966) (enjoining directors-majority stockholders from granting themselves stock options and bonuses). See also *Kavanaugh* v. *Kavanaugh Knitting Co.,* 226 N.Y. 185, 196, 123 N.E. 148, 152 (1919) ("A court of equity will protect a minority shareholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the shareholders."); *Gordon* v. *Ellman,* 306 N.Y. 456, 462, 119 N.E.2d 331, 335 (1954) (when equitable power is brought to bear, "the object is for the court to chart the course for the corporation which the directors should have selected, and which it is presumed they would have chosen

if they had not been actuated by fraud or bad faith."), *accord, Koral* v. *Savory, Inc.*, 276 N.Y. 215, 219, 11 N.E.2d 883, 845 (1937). The dissent also fails to take account of the liberalization of New York law by the Business Corporation Law, effective September 1, 1963. Section 720 of that statute provides:

> (a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:
>
> * * *
>
> (3) To enjoin a proposed illegal conveyance, assignment, or transfer of corporate assets, where there is sufficient evidence that it will be made.
>
> (b) An action may be brought for the relief provided in this section, and in paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.

As Judge (now Chief Judge) Breitel has written, "The statute is broad and covers every form of waste of assets and violation of duty whether as a result of intention, negligence, or predatory acquisition," *Rapoport* v. *Schneider*, 29 N.Y.2d 396, 400, 329 N.Y.S.2d 431, 435 (1972). Under the 1963 statute there can also be no question as to the applicability of these remedies to UGO. Section 1317 of the Business Corporation Law provides:

> (a) Except as otherwise provided in this chapter, the directors and officers of a foreign corporation doing business in this state are subject, to the same extent as directors and officers of a domestic corporation, to the provisions of:
>
> * * *
>
> (2) Section 720 (Action against directors and officers for misconduct.)
>
> (b) Any liability imposed by paragraph (a) may be enforced in, and such relief granted by, the courts of this state, in the same manner as in the case of a domestic corporation.

Apart from this and the provisions of § 1319 of the Business Corporation Law, defendants have not brought to our attention any Panamanian law similar to the Venezuelan prohibition against derivative actions that concerned the court in *Hausman* v. *Buckley,* 299 F.2d 696 (2 Cir.), *cert. denied,* 369 U.S. 885 (1962).

The availability of injunctive relief if the defendants had not lulled the minority stockholders of UGO into security by a deceptive disclosure, as they allegedly did, is in sharp contrast to *Green,* where the disclosure following the merger transaction was full and fair, and, as to the pre-merger period, respondents accepted "the conclusion of both courts below that under Delaware law they could not have enjoined the merger because an appraisal proceeding is their sole remedy in the Delaware courts for any alleged unfairness in the terms of the merger," fn. 14. Indeed, we have quite recently recognized that the availability of an injunctive action under New York law constituted a sufficient basis for distinguishing the conclusion in the *Green* footnote with respect to materiality, *SEC* v.

Parklane Hosiery Co., Inc., slip op. 4631, 4639 (2 Cir. July 8, 1977). While our brother Meskill is correct in stating that *Parklane* was an enforcement action by the SEC, we do not perceive why the test of materiality should be any different; indeed this court's seminal statement with respect to materiality was made in a SEC enforcement action, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-52 (2 Cir. 1968), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969), and contained no intimation that a stricter test would be applied in a private action.[9]

Defendants also rely on statements in Part IV of the *Green* opinion which lend them some support if taken in isolation and out of context. Thus the Court, quoting from *Piper* v. *Chris-Craft Industries, Inc.*, —— U.S. ——, —— (1977), 45 L.W. 4182, 4192, said that one factor in determining whether a case was covered by § 10(b) and Rule 10b-5, was "whether 'the cause of action [is] one traditionally relegated to state law. . . .'" But the Court quickly added, after referring to the Delaware appraisal statute, that "Of course, the existence of a particular state law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy," and it would be hard to think of a cause of action more "traditionally

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[9]The dissent's reliance on *Fershtman* v. *Schectman*, 450 F.2d 1357 (2 Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972), is misplaced. The limited partners who were the plaintiffs in that case were seeking rights greater than afforded by the partnership agreement on the basis of a "clarifying" letter from the defendants' attorney. Our holding was not that the difference between the letter and the agreement was not material, but that plaintiffs had not been deprived of any rights arising from the letter which they might have under state law. Here the nondisclosure or misleading disclosure allegedly deprived the corporation of proper action by its directors and the plaintiffs of an opportunity to bring a derivative action on behalf of UGO to enjoin the transaction with Maritimecor.

relegated to state law" than the one asserted in the *Superintendent of Insurance* case, which, as has been said, made "just plain stealing" a fraud under Rule 10b-5, on the basis that Begole failed to tell the directors "in advance that he was going to steal", *Jennings & Marsh, Securities Regulation* 997-98 (1977). Defendants rely also on the Court's fears of the difficulty of future line-drawing among various kinds of breach of fiduciary duty involving securities transactions. But this was said in support of drawing the line so as to require plaintiffs to make claims of non-disclosure or misleading disclosure, not as directing the lower courts to dismiss cases where it was claimed that fiduciaries had failed to disclose their self-dealing or had made a misleading disclosure, even though no disclosure was required by state law.[10] Similarly we fail to see how defendants gain from the Court's quotation of its statement in the *Superintendant of Insurance* case, 404 U.S. at 12, that "Congress by § 10(b) did not seek to regulate

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[10]We need not now decide whether, as some commentators have suggested, in certain self-dealing situations disclosure of the fact that the transaction is to occur or has occurred is required by federal law—whether as an affirmative duty on the corporation in some circumstances to disclose under Rule 10b-5 even in the absence of its trading, *Jacobs, The Impact of Rule 10b-5* § 88.04[a] (rev. ed. 1977); *see, e.g., SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 & n.12 (2 Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC* v. *North American Research & Development Corp.*, 424 F.2d 63, 79 n.13 (2 Cir. 1970); *Financial Indus. Fund, Inc.* v. *McDonnell Douglas Corp.*, 474 F.2d 514 (10 Cir. 1973); *Securities Act Release No. 5092* (Oct. 15, 1970), and other sources cited in *Jacobs, supra; compare Electronic Specialty Co.* v. *International Controls Corp.*, 409 F.2d 937, 949 (2 Cir. 1969), or as a requirement of applicable specific reporting provisions under the 1934 Act, *see, e.g.*, §§ 13 and 15(d); Form 10-K (Items 1 and 15); Form 8-K (Item 2), or as an obligation imposed by a national securities exchange, *see, e.g., NYSE Company Manual* A-18; *AMEX Company Guide; see also* Exchange Act Rule 15c2-11.

transactions which constitute no more than internal corporate mismanagement"—a statement that originally seemed intended only to remove *negligent* corporate misconduct from the reach of the statute. We readily agree that if all that was here alleged was that UGO had been injured by "internal corporate mismanagement", no federal claim would have been stated. But a parent's looting of a subsidiary with securities outstanding in the hands of the public in a securities transaction is a different matter; in such cases disclosure or at least the absence of misleading disclosure is required. It would be incongruous if Rule 10b-5 created liability for a casual "tip" in the bar of a country club, as we held in *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2 Cir. 1976), but would not cover a parent's undisclosed or misleadingly disclosed sale of its overvalued assets for stock of a controlled subsidiary with securities in the hands of the public.

The order dismissing the complaint is reversed and the case is remanded to the district court for further proceedings, including amendment of the complaint, consistent with this opinion.[11]

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[11]It should be apparent that we decide only that the complaint, with the amendment we have considered as if allowed, states a claim. Of course, we intimate no opinion concerning the factual correctness of any allegation nor do we mean to prejudice consideration of any legal issues possibly relevant to this case but not raised on this appeal. Thus, for example, we need not pass on whether any deception of director Siem might suffice as the requisite deception. See 1 *Bromberg, Securities Law: Fraud* § 4.7(543), at 84.57 (1973) (stating that "[i]t is not clear whether full disclosure at a board meeting permits a claim of deception of a director who is absent").

Opinion of Thomas J. Meskill, C.J.

MESKILL, *Circuit Judge,* concurring in part and dissenting in part:

I concur in Parts I and II of Judge Friendly's opinion, for I agree that the district judge should have allowed amendment of the complaint[1] and that a corporation may be defrauded by some or all of its directors. I part company, however, with the majority's holding that the complaint, as "amended" in the manner suggested by Judge Friendly, to include the press releases, states a cause of action. Assuming that any deception of the minority shareholders took place, the complaint nevertheless fails to establish that the claimed deception was "material."[2] Accordingly, I respectfully dissent from the discussion in Part III of the majority opinion concerning materiality and the impact of *Santa Fe Industries, Inc.* v. *Green,* 45 U.S.L.W. 4317 (U.S. March 23, 1977).

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[1]The allegation of deception was clearly insufficient under Fed. R. Civ. P. 9(b), which requires specificity in pleading fraud. *See Segan* v. *Dreyfus Corp.,* 513 F.2d 695 (2d Cir. 1975). This deficiency is understandable in view of appellant's stout insistence, throughout the district court proceedings, that 10b-5 had expanded to a point where an allegation of deception was no longer required. His principal support for this contention was our decisions in *Green* v. *Santa Fe Industries, Inc.,* 533 F.2d 1283 (2d Cir. 1976) and *Marshel* v. *AFW Fabric Corp.,* 533 F.2d 1277 (2d Cir. 1976). At that point, fraudulent deception was merely a makeweight. Following the Supreme Court reversal in *Green,* appellant shifted his emphasis on appeal, and recast his case to center on the alleged deception.

[2]As the majority concedes, the directors were under no obligation to denounce their own proposal, no matter how malign their intent. Thus, the omitted "facts" upon which the amended complaint is based are the failure to include the actual amount of Maritimecor's assets and liabilities in the press release, and a false representation that the transaction would inure to the benefit of UGO. While these are probably sufficient to survive a motion to dismiss, they amount to little more than that. The information on Maritimecor was almost undoubtedly in the hands of the public through its annual reports and filings with the SEC.

The test of materiality in securities law has recently been laid out by the Supreme Court. In *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), which dealt with an alleged omission under Rule 14a-9, Justice Marshall stated:

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills'* general description of materiality as a requirement that "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id. at 449 (footnote omitted). *See Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973); *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965) ("The basic test of 'materiality,' on the other hand, is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.'").[3]

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[3]The test of materiality under 14a-9 and 10b-5 is the same. *See Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Gilbert* v. *Nixon*, 429 F.2d 348, 355 (10th Cir. 1970).

Under Panamanian law, no shareholder action was necessary to effect the UGO-Maritimecor merger. Accordingly, the burden is on the plaintiffs to demonstrate a substantial likelihood that they would have acted differently had full disclosure been made.[4]

For example, in *Fershtman* v. *Schectman*, 450 F.2d 1357 (2d Cir. 1971), we dealt with a "forced sale" of limited partnership interests made under the partnership agreement. The general partners were given the sole power to make this decision. The limited partners brought suit, claiming that a number of misleading statements and nondisclosures were made concerning the termination. The Court held that these allegations, even if true, did not meet the requirement of materiality:

> [I]f defendants were legally entitled to terminate the partnership on March 31, 1968, in their sole discretion, it would make no difference what they misrepresented or concealed, even if we assume in plaintiff's favor that this transaction constituted a sale.

Id. at 1360.[5]

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[4]The majority's heavy reliance on our *en banc* opinion in *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969) is misplaced for two reasons. First, materiality was not discussed in *Schoenbaum*, since the district court had granted summary judgment on another issue. Second, *Schoenbaum* held that a breach of fiduciary duty, there the issuance of stock for inadequate consideration, was actionable under clause (3) of Rule 10b-5. *Id.* at 219-20. This holding had been overruled by *Green*.

[5]While it is true that *Fershtman* relies in part on the panel opinion in *Drachman* v. *Harvey*, 453 F.2d 722 (2d Cir. 1971), *rev'd*, 453 F.2d 736 (2d Cir. 1972) (*en banc*), that aspect of the holding was not disturbed by the *en banc* Court. Moreover, *Schoenbaum* v. *Firstbrook* had already been decided at the time.

Fershtman is apposite on another ground. The Court held there that a state remedy, reformation of the partnership agreement, was available. Presumably, full disclosure would have aided the plaintiffs in state court. However, the existence of this state remedy was not deemed relevant to the existence of the federal cause of action.

Although the majority asserts that state remedies were available to halt the merger, the explanation of what they were is unpersuasive. The principal action suggested by the majority opinion is an injunction[6] against the proposed merger. The theory is apparently that the shareholders, who were led down the primrose path by the misleading press releases, would have raced into court if armed with the full story. It is possible that plaintiffs could have obtained an injunction under New York's Martin Act, N.Y. Gen. Bus. Law § 352 *et seq.* (McKinney 1976). *See American Bank & Trust Co.* v. *Barad Shaff Securities Corp.*, 335 F.Supp. 1276 (S.D.N.Y. 1972).[7] In order to prove

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[6]In our recent decision in *S.E.C.* v. *Parklane Hosiery Co.*, slip op. 4631 (2d Cir. July 8, 1977), we held that the availability of a state injunction was relevant in deciding materiality in an SEC enforcement action. The court carefully distinguished that case from a private action for damages. *Id.* at 4638-39. While the majority contends that this distinction is unimportant, *Parklane* holds to the contrary.

[7]The availability of an injunction, rather than damages, in a private action under the Martin Act is unclear. *See People* v. *Concord Fabrics, Inc.*, 83 Misc.2d 120, 371 N.Y.S.2d 550, 553 (Sup. Ct. N.Y. County 1975), *aff'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1st Dept. 1976). An injunctive action is usually brought by the State Attorney General. However, a nondisclosure to the stockholders which might have prompted the Attorney General to sue cannot possibly give Goldberg a cause of action.

A second possibility is a lawsuit to enjoin the transaction as a breach of the statutory fiduciary obligation imposed on majority shareholders. *See* N.Y.B.C.L. § 720 (McKinney 1963). Here again, the right to enjoin the alleged misconduct here is unclear. *Compare Blumenthal* v. *Roosevelt Hotel, Inc.*, 202 Misc. 988, 115 N.Y.S.2d 52 (Sup.Ct. N.Y. County 1952) (Breitel. J.), *with Williams* v. *Bartell*, 34 Misc.2d 552, 226 N.Y.S.2d 187 (Sup.Ct. N.Y. County), *modified*, 16 A.D.2d 21, 225 N.Y.S.2d 351 (1st Dept. 1962). Thus, the claim for relief depends on uncertain aspects of state law. This underscores the correctness of Judge Lasker's holding that the federal interest was slight, if it existed at all.

The majority may be correct concerning the availability of injunctive relief in the state court. That is not the issue, however. The plaintiffs have not even alluded to the element of materiality, which is their burden to establish. Our Court should not carry that burden for them.

materiality under this theory, Goldberg will have to demonstrate that he would, as a reasonable stockholder, have sought and obtained an injunction against the proposed action had the facts not been concealed.[8] *See Herzfeld* v. *Laventhal, Krekstein, Horwath & Horwath,* 378 F.Supp. 112 (S.D.N.Y. 1974), *mod. on other grounds,* 540 F.2d 27 (2d Cir. 1976).

Moreover, the plaintiff fails even to mention in his two complaints what course of action he contemplated taking. Under *Green,* such an allegation is required to state a claim under 10b-5. There, as here, a plaintiff who sought to recover in federal court for a breach of fiduciary duty appended a conclusory allegation of deception. The Court stated:

> In addition to their principal argument that the complaint alleges a fraud under clauses (a) and (c) of Rule 10b-5, respondents also argue that the complaint alleges nondisclosure and misrepresentation in violation of clause (b) of the Rule. Their major contention in this respect is that the majority stockholder's failure to give the minority advance notice of the merger was a material nondisclosure, even though the Delaware short-form merger statute does not require such notice. Brief for Respondents, at 27. *But respondents do not indicate how they might have acted differently had they had prior notice of the merger.* Indeed, they accept the conclusion of both courts below that under Delaware law they could not have enjoined the merger because an appraisal proceeding is their sole remedy in the Delaware courts for any alleged unfairness in the terms of the merger. Thus the failure to give advance notice

[8]Given the alacrity with which actions taken by controlling shareholders are challenged in federal court, one can easily envision a suit seeking an injunction on the grounds that full disclosure would have led the plaintiff to seek an injunction.

was not a material nondisclosure within the meaning of the statute or the Rule.

45 U.S.L.W. at 4320 n.14 (emphasis added) (citation omitted). I do not understand the remand to have relieved the plaintiff of his burden of pleading and proving the availability of state relief.[9]

The majority suggests two other bases for a finding of materiality. The first is the artificial maintenance of the price of UGO stock through nondisclosure. While this would be relevant in the action brought by the SEC or a plaintiff suing in his individual capacity,[10] I fail to see what relevance this has in a derivative action. In his repre-

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[9]According to defendants' papers, UGO is a Panamanian corporation with principal offices in New York and Bermuda, and Maritimecor is a Panamanian corporation with its principal place of business in Zurich, Switzerland. Apparently, all but two of the defendants live outside of the United States, and are citizens of foreign countries. While New York's fiduciary standards will be applied in such an action for damages, *see German-American Coffee Co.* v. *Diehl,* 216 N.Y. 57, 109 N.E. 875 (1915) (Cardozo, *J.*), it is not all clear that New York law determines the availability of an injunction in this situation in spite of the provisions of § 1317 of the General Business Law. *See Hausman* v. *Buckley,* 299 F.2d 696 (2d Cir.), *cert. denied,* 369 U.S. 885 (1962). *See* Reese & Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum.L.Rev. 1118 (1958); Loss, The Conflict of Laws and the Blue Sky Laws, 71 Harv.L.Rev. 209 (1957); Currie, The Constitution and Choice of Law, 26 U. Chi.L.Rev. 9 (1958). Thus, in *Green,* the Supreme Court looked only to the availability of an injunction in Delaware, the state of incorporation. Neither the majority nor the plaintiff discusses this difficult choice-of-law issue. This unsettled question of state law may prove dispositive on the question of materiality. Moreover, if New York would grant an injunction and other states would not, the majority will have created a federal right, the existence of which depends on the venue of the suit brought to enforce it. On the other hand, if the availability of an injunction in New York determines the issue of materiality for every federal court, then the New York Legislature will have set the standard under Rule 10b-5 for the nation.

[10]An individual suit by Goldberg under 10b-5 would appear to founder on the purchaser-seller requirement of *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975).

sentative capacity, Goldberg may assert only the rights of UGO. It is self-evident that the artificial maintenance of a high price for its stock in no way injured UGO.[11]

The final suggested rationale of the majority is the "chastening effect" of full disclosure. The apparent theory is that those about to loot a corporation can be shamed into honesty through a requirement that they reveal their nefarious purposes.[12]

Even the high-water mark of expansion for 10b-5, *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), acknowledged that breaches of fiduciary obligation were governed by state, and not federal, law. *Id.* at 12. The primary role of the states in these matters has been emphasized in a number of recent opinions of the Supreme Court. *See, e.g., Green, supra* at 4321; *Piper* v. *Chris-Craft Industries, Inc.*, 45 U.S.L.W. 4182 (U.S. Feb. 23, 1977); *Court* v. *Ash*, 422 U.S. 66, 78 (1975).

Those who breach their fiduciary duties seldom disclose their intentions ahead of time. Yet under the majority's reasoning the failure to inform stockholders of a proposed defalcation gives rise to a cause of action under 10b-5. Thus, the majority has neatly undone the holdings of *Green, Piper* and *Cort* by creating a federal cause of action for a

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[11]To the contrary, the high price of UGO stock would appear to be a benefit to the corporation. Furthermore, it is hardly fitting for Goldberg to seek equitable remedies on the ground that, properly informed, he could have unloaded his stock on some unsuspecting third party. Of course, if Goldberg told the truth to the prospective purchaser, a sale was unlikely. Very few, except those interested in purchasing stockholder suits, would be willing to invest in a company after the controlling shareholders have announced an intention to loot it.

[12]Such a disclosure would be material, since every jurisdiction would enjoin such conduct. If the majority is merely referring to the "chastening effect" of factual disclosure to shareholders who can do nothing to stop the proposed action, lack of materiality is still a barrier under Rule 10b-5.

breach of fiduciary duty that will apply in all cases, save for those rare instances where the fiduciary denounces himself in advance.

If the defendants have looted UGO in the manner alleged by the plaintiffs, a full recovery should not be difficult to obtain. Under New York state law, this would be a breach of the fiduciary duty imposed upon directors. My dissent is not based upon any desire to insulate such business practices from legal redress, but upon the fact that the plaintiff has chosen the wrong forum.

It is also noteworthy that, following a practice we have "unreservedly condemn[ed]," *Rosenfeld* v. *Black*, 445 F.2d 1337, 1341 n.5 (2d Cir. 1971), *cert. dismissed under Rule 60*, 409 U.S. 802 (1972), Goldberg has filed a parallel action on behalf of UGO in New York State Supreme Court. This only serves to reinforce what I have sought to demonstrate, namely, that this complaint sounds entirely in state law. There can be no doubt that the State Supreme Court has wide experience in corporate matters similar to this, and can afford complete relief if Goldberg's allegations are borne out at trial. Accordingly, I would remand with instructions to allow an amendment to the complaint.

Memorandum of Morris E. Lasker, J.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

76 Civ. 555

DAVID GOLDBERG, suing derivatively in the right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC.,
Plaintiff,

—against—

YAACOV MERIDOR, *et al.*,
Defendants.

—and—

UNIVERSAL GAS & OIL COMPANY, INC.,
Nominal Defendant.

MEMORANDUM

LASKER, *D. J.*

David Goldberg sues derivatively on behalf of Universal Gas & Oil Co., Inc. (UGO), charging UGO's officers and its two parent corporations with corporate mismanagement and breach of fiduciary duty. Specifically, Goldberg challenges a transaction between UGO and Maritimecor, S.A., whereby UGO issued 4,200,000 shares of its stock to Maritimecor in return for all of the latter's assets and liabilities. Prior to the transaction Maritimecor owned 78% of UGO, and was in turn wholly owned by the defendant Maritime Fruit Carriers Co., Ltd. (MFCC). Goldberg alleges that the terms of this transaction were grossly "unfair" to the minority shareholders of UGO and that the transaction

itself constituted a violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 40 C.F.R. 240.10b-5.[1]

According to the Amended Verified Complaint, the defendants conspired to enrich Maritimecor and MFCC at the expense of UGO. The plan was effected by raising funds from the public and using the proceeds for the benefit of the two corporate defendants. (¶ 10) (Numbers in parentheses refer to the paragraphs of the Amended Verified Complaint) In furtherance of this scheme the following events took place:

1) In May, 1972 UGO sold stock and debentures in a public offering for the stated purpose of raising funds to finance the construction and purchase of three ships to transport liquified gas; (¶ 11)

2) In 1974 two of the ship construction contracts were sold for a $14 million profit; (¶ 12)

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[1]In the original Verified Complaint Goldberg alleged as well that the defendants' conduct constituted a breach of fiduciary duty under state law. The defendants moved for an order directing Goldberg to post security for expenses and costs as required under Section 627 of the New York Business Corporation Law. The motion was granted and on July 29, 1976 an order was entered directing, *inter alia*, that Goldberg would either post security, rally support from other UGO shareholders sufficient to be exempted from the security requirement, or amend the complaint to eliminate causes of action based upon state law.

Thereupon Goldberg filed the Amended Verified Complaint (Amended Complaint), containing essentially the same allegations but omitting any reference to a state law claim. Nevertheless, the amended complaint avers that "Plaintiff believes, *without limitation*, that the Court may find § 10(b) of the Exchange Act and of Rule 10b-5 . . . applicable to the facts which plaintiff will prove." (¶ 25, Amended Complaint) (emphasis supplied) This unusual pleading strongly suggests that Goldberg still intends to leave open the possibility of recovering under state law.

3) In 1974 and 1975 the defendants caused loans to be made by UGO to Maritimecor so that by August, 1975 Maritimecor owed UGO $7 million; (¶ 13)

4) In August, 1975 UGO agreed to issue 4,200,000 shares of its stock to Maritimecor in exchange for all of the latters' assets (excluding 2,800,000 shares of UGO already held by Maritimecor) and liabilities. (¶ 14)

The purchase of Maritimecor's assets and liabilities, which Goldberg believes has been effected, (¶ 15), was "fraudulent and unfair" in that the net value of Maritimecor's assets was far less than the value of the UGO shares exchanged, and "the purpose and intent of said transaction was to cause the dissipation of the substantial assets of UGO for benefit of the defendants Maritimecor and [MFCC]." (¶ 16) The defendants were fully aware that the transaction had no business purpose, had no benefit for UGO, was not an arm's length transaction and represented self-dealing and breach of fiduciary duty. (¶ 18)

Although these allegations clearly constitute a valid state law claim, their sufficiency in federal law is open to serious question. Conspicuously absent is any allegation of deceit, misrepresentation or falsehood with regard to the the events which transpired. Urging that the lack of any claimed deception is fatal to a cause of action under Rule 10b-5, many of the defendants move to dismiss for failure to state a claim. Fed. R. Civ. P. 12(b)(6).[2]

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[2]In the alternative they seek to require Goldberg to post security for expenses and costs. Since, as explained in Note 1, *supra*, we agree with the defendants that state law claims are implicit in the amended complaint despite the absence of direct reference to them, we would be inclined to grant the motion for security absent an express waiver of intent to recover on common law causes of action. Our disposition of the motion to dismiss, however, makes such a ruling unnecessary.

Memorandum of Morris E. Lasker, J.

Until fairly recently there was little room for doubt that the defendants' position is correct. The element of deception has always been a central component of a 10b-5 violation. See, e.g., *O'Neill* v. *Maytag,* 339 F.2d 764 (2d Cir. 1964). Although decisions like *Drachman* v. *Harvey,* 453 F.2d 772 (2d Cir. 1972) (en banc) and *Schoenbaum* v. *Firstbrook,* 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 906 (1969) significantly expanded the scope of the Rule, finding claims to be stated where the essence of the allegations involved corporate self-dealing in relation to securities transactions, the element of deceit remained present, albeit somewhat less central to the challenged behavior. In *Popkin* v. *Bishop,* 464 F.2d 714 (2d Cir. 1972), the court reaffirmed that deception is an indispensible element of a 10b-5 claim. The *Popkin* court analyzed the more expansive prior decisions and concluded that their focus on improper self-dealing "did not eliminate non-disclosure as a key issue in Rule 10b-5 cases." 464 F.2d at 719.

Goldberg argues that all of this has been changed by two recent landmark decisions in this Circuit. In *Marshel* v. *AFW Fabric Corp.,* 533 F.2d 1277 (2d Cir.), *vacated and remanded for consideration of mootness,* 45 U.S.L.W. 3279 (Oct. 12, 1976) and *Green* v. *Santa Fe Industries, Inc.,* 533 F.2d 1283 (2d Cir.), *cert. granted,* 45 U.S.L.W. 3249 (Oct. 4, 1976), the court held that it is not necessary to plead or prove deception in the context of a challege under Rule 10b-5 to a merger effectuated for the purpose of "going private." Goldberg contends that this case is governed by *Marshel* and *Green* because here, as in those cases, "the transaction itself is attacked as a fraud on UGO." (Memorandum in Opposition at 7) The defendants argue that *Popkin* controls. We agree.

Memorandum of Morris E. Lasker, J.

Popkin was a derivative action brought by a shareholder in Bell Intercontinental Corp. to enjoin a proposed merger of Bell and two of its subsidiaries into the Equity Corporation, which was the controlling entity of the other three corporations. The plaintiff alleged that the terms of the deal were grossly inadequate to the shareholders of Bell and that the officers and directors of the corporation breached a variety of fiduciary duties in advocating the transaction. Nevertheless, despite its recognition that *Drachman* and *Schoenbaum* had significantly extended the reach of 10b-5 to include claims of corporate mismanagement and self-dealing in connection with securities transactions, the court upheld the lower court's dismissal of the complaint for failure to state a claim. The fatal defect was the absence of an "allegation or hint of any misrepresentation by defendants or failure on their part to disclose any material fact in connection with the merger proposal." 464 F.2d at 718.

Marshel was a derivative suit brought by minority shareholders in Concord Fabrics Inc., who sought to enjoin a merger between Concord and AFW Fabrics Corp., an entity created and wholly owned by the majority shareholders of Concord for the sole and express purpose of "going private." The merger was to be effectuated under the New York corporation law which requires approval by shareholders vote, but the result was a foregone conclusion because the majority interests held enough shares to determine the outcome. The plaintiffs conceded that the terms, purpose and effect of the proposed merger had been fully disclosed. The court, however, viewed the merger as a

> "scheme by [the majority], having previously taken advantage of public financing, to appropriate for their personal benefit the entire stock ownership of

> Concord at a price determined by them and paid out of the corporate treasury at a cost of over $1,600,000." 533 F.2d at 1280.

Such a scheme was held to be within the proscription of 10b-5. The court framed its holding carefully and narrowly:

> "We hold that when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5 which prohibits 'any act, practice, or course of business which operates or would operate as a fraud . . . in connection with the purchase or sale of any security.' " 533 F.2d at 1281.

Green reached the same conclusion where the challenged transaction was a Delaware short-form merger under which no prior notice to or approval by the shareholders was required. Like *Marshel* the opinion is spiced with language expressing the fundamental unfairness and artifice of a "going private" merger and held only that "a complaint alleges a claim under Rule 10b-5 when it charges in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose." 533 F.2d at 1291.

It is, as Judge Smith noted in his concurrence in *Marshel,* somewhat difficult to reconcile the holdings of these two cases, and particularly *Marshel,* with *Popkin.* Never-

theless, neither decision purported to overrule *Popkin* and in fact, both asserted that it supports their holdings. The court in *Green* distinguished *Popkin* primarily on the ground that in the latter shareholder approval was required to effectuate the challenged merger. Therefore a requirement of full disclosure would presumably suffice to protect the interests of minority owners. In contrast, since the Delaware short-form merger under attack in *Green* did not require prior notification, lack of disclosure or misrepresentation was unnecessary to the claim. 533 F.2d at 1289-90. This distinction, however, is not entirely satisfactory, particularly since the merger in *Marshel* was one which required shareholder approval. If the distinction suggested in *Green* were dispositive, *Marshel* would have gone the other way.

Goldberg argues that the line between those cases governed by *Green* and *Marshel* on the one hand, in which no allegation of deception is required, and those governed by *Popkin* on the other, should be drawn between those cases in which the challenged transaction is attacked as inherently fraudulent and those in which it is not. In support of this interpretation he seizes on the passage in *Marshel* in which the court, contrasting the facts of *Popkin*, noted that in the earlier case, "The propriety of the merger itself was not challenged." 533 F.2d at 1282. Because he claims to be challenging the transaction between UGO and Maritimecor as a fraud on UGO's minority shareholders, he argues that he falls within the ambit of the *Marshel* holding. This, however, is unduly simplistic. It reduces the distinction between the cases to semantics, and renders *Popkin* and a long line of prior decisions virtually meaningless, subject to circumvention by any plaintiff with counsel sufficiently artful to word the complaint so as to avoid any reference to such things as an unfair exchange ratio and substitute

phrases like "inherently fraudulent scheme." We think the *Marshel* court must have meant more than this. Indeed, this conclusion is supported by the court's statement elaborating on the contrast between the facts in *Popkin* and the facts before it, that, "In the present case the 'merger' itself constitutes a fraudulent scheme *because it represents an attempt by the majority stockholders to utilize corporate funds for strictly personal benefit.*" 533 F.2d at 1282 (emphasis added). The reference here to "strictly personal benefit" seems peculiarly directed to the "going private" context, in which the gains sought by defendants are particularly and exclusively individual in nature.

We conclude, along with the Court of Appeals for the Sixth Circuit, that *Green* and *Marshel* deal with a subject *sui generis* and "cannot be read apart from the milieu of 'going private' merger transactions." *Marsh* v. *Armada Corp.*, 533 F.2d 978, 985, *petition for cert. filed,* No. 76-5, 45 U.S.L.W. 3103 (July 6, 1976). There is something inherently suspect in the decision of a small group of individuals when, after cashing in on the "going public craze" they then move for their own financial advantage to eliminate public investors from participation in ownership, and do so with corporate funds. It suggests an analogy the car thief who makes the owner pay for the gas to drive the car away. In *Green* Judge Medina put it that:

> "When controlling shareholders of a publicly held corporation use corporate funds to force extinction of the minority shareholders' interest for the sole purpose of feeding the pocketbooks of the controlling shareholders, such conduct goes beyond mere negligent mismanagement and is properly cognizable as 'an act, practice, or course of conduct which operates or would operate as a fraud . . .' " 533 F.2d at 1290.

This sentiment appears throughout both opinions and must be considered to lie at the heart of their holdings. Although the issue is not free of difficulty, nevertheless we conclude that the cases should be limited to their facts, and so long as *Popkin* remains good law the element of deception should be understood as a requirement of a 10b-5 claim with the sole exception of actions challenging a "going private" merger.[3]

Goldberg has indicated a desire to replead and allege deception of the minority shareholders in the event that the motion to dismiss is granted. While such a course is frequently appropriate, in the circumstances of this case we decline to permit it.

There have already been two complaints. (See notes 1 and 2) Both are prime examples of an attempt to fit the square peg of a state law claim into the round hole of a 10b-5 allegation. When the original complaint was dismissed for failure to post security or obtain the requisite support from other minority shareholders, Goldberg was made exquisitely aware of the need to limit this amended pleading to a federal claim, unless he could post security under state law, which he could not. Although he now contends that he could allege that he was deceived by the defendants with regard to the terms of the transaction with Maritimecor, he chose to frame the amended complaint in such a way as to exclude this element altogether. There is a limit to the time and energy a federal court should accord

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[3] *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), is not to the contrary. It is, of course, true, as reiterated in *Schlick*, that a 10b-5 complaint is not deficient merely because it alleges malfeasance which would also be grounds for suit under state law. 507 F.2d at 379-80. All of the cases cited in this portion of the *Schlick* opinion, however, involved an element of deception, as did *Schlick* itself.

to marginal federal causes of action which are fully capable of being vindicated in state court. Presumably, if the element of deceit formed any significant aspect of Goldberg's claim, or was responsible for the alleged injury to UGO, Goldberg could have been expected to have plead such facts before the third go-round.

For the foregoing reasons, the motion to dismiss is granted.

It is so ordered.

MORRIS E. LASKER
U.S.D.J.

Dated: New York, New York
February 10, 1977.

Correcting Memorandum of Morris E. Lasker, J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

76 Civ. 555

DAVID GOLDBERG, suing derivatively in the right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC.,
Plaintiff,

—against—

YAACOV MERIDOR, *et al.*,
Defendants,

—and—

UNIVERSAL GAS & OIL COMPANY, INC.,
Nominal Defendant.

CORRECTING MEMORANDUM

LASKER, *D. J.*

In my Opinion dated February 10, 1977, an additional footnote is being added. The number "4" is to be added after the word "granted" at the top of Page 11 and the following footnote is to be added to Page i. of the FOOTNOTES.

> "4. Since this Memorandum was filed the Supreme Court reversed *Green,* squarely holding that deception is an indispensable element to a 10b-5 claim. *Sante Fe Industries, Inc.* v. *Green,* —— U.S. ——, 45 U.S.L.W. 4317, March 23, 1977. Although the decision renders the above analysis moot, it lends substantial support to the end result."

Dated: New York, New York
March 28, 1977.

MORRIS E. LASKER
U.S.D.J.

Order

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket Number
77-7146

DAVID GOLDBERG, suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC.,
Plaintiff-Appellant,

—v.—

YAACOV MERIDOR, *et al.*,
Defendants-Appellees,

—and—

UNIVERSAL GAS & OIL COMPANY, INC.,
Nominal Defendant.

Defendants-Appellees having petitioned for rehearing and having suggested that such rehearing be *in banc,* it is ordered (1) that the last line on p. 5818 of this court's opinion be modified by substituting the words "a fraudulent" for the words "an unfair", and (2) that the petition for rehearing by the panel be denied.

HENRY J. FRIENDLY
Henry J. Friendly

WILLIAM H. TIMBERS
William H. Timbers
Circuit Judges

I dissent from so much of the order as denies the petition for rehearing.

THOMAS J. MESKILL
Thomas J. Meskill
Circuit Judge

Filed:
Oct. 21, 1977
A. Daniel Fusaro, *Clerk*

STATUTES AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Section 9(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(e):

Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

Section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a):

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected

by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

NEW YORK BUSINESS CORPORATION LAW § 627:

Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor.

In any action specified in section 626 (shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), unless the plaintiff or plaintiffs hold five percent or more of any class of outstanding shares or hold voting trust certificates or a beneficial interest in shares representing five percent or more of any class of such shares, or the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorneys' fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter, under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall

determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.

TITLE 28 UNITED STATES CODE § 1652:

State laws as rules of decision

The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil action in the courts of the United States, in cases where they apply.

Supreme Court, U. S.
FILED
FEB 2 1978
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1977

77-

No. 897

YAACOV MERIDOR and MILA BRENER,

Petitioners,

—v.—

DAVID GOLDBERG suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC., HENRY A. SINGER, ARA A. CAMBERE, H. STRUVE HENSEL, DAVID MERIDOR, S. ERELL, GIDEON BEN AARON, HAIM RAFAELI, JACOB SUTTON, MARTIN SIEM, MARITIMECOR, S.A., MARITIME FRUIT CARRIERS COMPANY, LTD., and UNIVERSAL GAS & OIL COMPANY, INC.,

Respondents.

77-

No. 940

HENRY A. SINGER,

Petitioner,

—v.—

DAVID GOLDBERG suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC., YAACOV MERIDOR, MILA BRENER, ARA A. CAMBERE, H. STRUVE HENSEL, DAVID MERIDOR, S. ERELL, GIDEON BEN-AARON, HAIM RAFAELI, JACOB SUTTON, MARTIN SIEM, MARITIMECOR, S.A., MARITIME FRUIT CARRIERS COMPANY, LTD., and UNIVERSAL GAS & OIL COMPANY, INC.,

Respondents.

BRIEF IN OPPOSITION TO THE PETITIONS FOR WRITS OF CERTIORARI

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BRIEF IN OPPOSITION TO THE PETITIONS FOR WRITS OF CERTIORARI

QUESTIONS PRESENTED

1. Whether the unanimous finding of the Court of Appeals that further amendment to the complaint should have been permitted to include reference to the two press releases or otherwise to claim deception, merits review by this Court?

2. Whether a majority of the Second Circuit Court of Appeals was correct in deciding that a cause of action exists under Section 10(b) of the Securities Exchange Act on behalf of a subsidiary when its parent causes the subsidiary to sell its securities to the parent in a fraudulent transaction and fails to make a disclosure or makes a misleading disclosure?

STATEMENT OF THE CASE

This is a derivative action, commenced by David Goldberg, a stockholder of Universal Gas & Oil Company, Inc. (UGO), a Panama corporation with its principal place of business in New York City.

The action seeks to recover damages and other relief against UGO's parent corporation, Maritimecor, S.A., also a Panama corporation, Maritimecor's parent, Maritime Fruit Carriers Company Ltd., an Israeli corporation, directors of one or more of these corporations, and an investment firm and an accounting firm. Defendants are charged with violating § 10(b) of the Securities Exchange Act and Rule 10b-5.

Goldberg's original complaint, filed on February 3, 1976, was met with a motion for a stay pending the posting of security

for costs and expenses under § 627 of the New York Business Corporation Law. The district court ruled that Goldberg had to satisfy the exemptions under the statute, or post security in an amount to be determined, or amend the complaint to delete all state law claims.

Goldberg chose to amend the complaint. The amended complaint alleges a scheme to defraud UGO beginning with the raising of public funds through an offering in May 1972. The UGO prospectus stated the proceeds would be used to finance the construction and purchase of three vessels for transporting liquified gases and that UGO's business would be transporting liquified gas. Thereafter, in 1974, UGO sold contracts for construction of two of these vessels for $25,000,000, realizing a profit of $14,000,000. At the same time UGO was selling off its assets, the cash proceeds were being used to finance

the operation of its parent, Maritimecor. Maritimecor borrowed a total of $7,000,000 from UGO throughout 1974 and up thru August 1975.

The alleged fraud culminated in an agreement in August 1975 between Maritimecor and UGO by which UGO was to issue up to 4.2. million shares of its stock to Maritimecor for all the latter's assets, except for the 2.8 million UGO shares it already owned, and all of Maritimecor's liabilities including the $7,000,000 it owed UGO. The agreement was carried out to the extent that Maritimecor transferred its assets and liabilities to UGO. The amended complaint alleges that the amount of Maritimecor's liabilities far exceeded its assets and that this transaction constituted a fraud and deception of UGO.

A motion to dismiss the amended complaint was made asserting that it failed to state a claim under §10(b) of the Securities

Exchange Act and Rule 10b-5. In opposition to the motion, an affidavit was submitted attaching two press releases issued by UGO, one in August, and the other in December 1975. These were the only press releases concerning the securities transaction between UGO and Maritimecor. Petitioners have never disputed that both of these press releases antedated the transfer of Maritimecor's assets and liabilities to UGO and that both were misleading and failed to disclose the necessary details of the transaction. Neither release made any reference to (1) the amounts of Maritimecor's assets and liabilities, (2) the fact that the $7,000,000 loaned by UGO was in effect being forgiven, and (3) the fact that Maritimecor as of the end of fiscal 1974 had current liabilities of $42.5 million. On the contrary, the two releases painted the transaction in positive terms. Goldberg charged that as

a result of this transaction UGO, which at the end of 1974 had current assets of about $41 million and current liabilities of $2 million wound up with a net deficit of about $3.6 million of current liabilities, became insolvent, defaulted on its obligations and the value of its shares substantially decreased. Goldberg pointed out that no discovery had been permitted pending resolution of the two motions and asked for leave to amend to set forth the facts contained in the affidavit.

Judge Lasker refused to permit a further amendment of the complaint and decided that the amended complaint failed to plead deception or nondisclosure.

The Court of Appeals for the Second Circuit, on September 8, 1977, reversed. The Court unanimously held it was error to deny leave to amend as requested and then the Court with one judge dissenting,

considered the two press releases as part of the amended complaint, and held it sufficiently alleged deception and nondisclosure under Section 10(b).

PRELIMINARY STATEMENT

The Court of Appeals' opinion, permitting a further amendment of the complaint and holding that the District Court's refusal to permit such further amendment was an abuse of discretion, is consistent with the liberality accorded amendments where answers have not been served and discovery has not been held. In addition, in support of its opinion on this issue, the Court of Appeals noted that the application to replead was actually the first amendment sought to allege further facts of nondisclosure or misdisclosure.

It is further submitted that the majority opinion below, in finding a cause

of action under Section 10(b), is entirely consistent with the decisions of this Court. It follows the teachings of the most recent cases, Santa Fe Industries Inc. v. Green, 430 U.S. 462 (1977) and TSC Industries Inc. v. Northway Inc., 426 U.S. 438 (1976).

Petitioners' threatened flood of cases into the federal courts alleging corporate mismanagement "involving a parent-subsidiary transaction and a security" is unsupportable. First, the law as it exists today permits such claims in federal court as an action within Section 10(b). There has not been a "flood" of litigation and the instant case in no way increases the likelihood of such an eventuality. Second, simply because petitioners label such cases as "essentially state court claims" begs the question of whether or not this case widens the scope of cases cognizable under

Section 10(b). We submit it does not. On the contrary the majority opinion below followed a long line of cases in upholding federal jurisdiction on the facts of this case.

ARGUMENT

The Second Circuit Properly Found These Facts to Constitute the Required Deception

Petitioners first claim the Second Circuit erroneously found deception. They state at p. 8 of the Meridor-Brener petition:

> Here no deception or manipulative conduct in connection with the transaction is alleged.

This completely overlooks the two press releases which directly concern this transaction and described it so favorably. The Second Circuit found that the first, the August release, held "out an inviting picture" for UGO after the transaction. (Meridor-Brener, p.8a).*/ Goldberg, on the

*/ References are to pages in the indicated petitions.

contrary, asserts that the transaction led to UGO's doom. Both releases failed to disclose the facts of the transaction. The purpose of the transfer was not to benefit UGO, but simply to get UGO to pay its parent's liabilities out of UGO's own ample corporate funds. The Second Circuit made a specific finding at fn. 8 to its opinion that if the facts alleged by Goldberg were true, "...a disclosure of the acquisition of Maritimecor that omitted these facts would be seriously misleading." (Meridor-Brener p.19a). (Emphasis in original).*/ At no time

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*/ Even the dissenting opinion, in referring to Goldberg's allegations, states:

> While these are probably sufficient to survive a motion to dismiss, they amount to little more than that. (Meridor-Brener p.27a).

have petitioners disputed Goldberg's facts or his charge that these releases were misleading and deceptive.

Petitioners further argue that because all the directors, or at least more UGO directors than were needed to vote in favor of the Maritimecor transaction, are charged with the fraud there can be no deception as a matter of law. They urge that since all the directors knew the facts alleged by Goldberg they couldn't be deceived. Reliance is placed on Santa Fe v. Green, supra at 475. But Santa Fe really has very little to do with this case. In Santa Fe it was concluded that there was full disclosure to the minority shareholders of all relevant information concerning the merger. Here Goldberg has charged the very opposite. There was a failure to disclose the facts of the transaction and such disclosure as was made was misleading. Moreover, Santa Fe deals with

disclosure to minority shareholders and this Court's only reference to deception of directors is at footnote 15 of its opinion. While this Court's only comment is that all the cases cited therein have an element of deception, it would seem that the footnote indicates approval of the Second Circuit's analysis of deception in cases where the allegation is that the entire board of directors participated in the fraud. The footnote states: "majority stockholder and board of directors 'were guilty of deceiving' the minority stockholders", citing Schoenbaum v. Firstbrook, 405 F.2d 215,220 (2nd Cir. 1968), (en banc), cert. denied, 395 U.S. 906 (1969) and quotes from Pappas v. Moss, 393 F.2d 865,869 (3rd Cir. 1968):

> "...if a 'deception' is required in the present context [of §10(b) and Rule 10b-5], it is fairly found by viewing this fraud as though the 'independent' stockholders were standing in place of the defrauded corporate entity..."

Thus, the Second Circuit's opinion follows a long line of cases supporting a derivative action under Section 10(b), even against all the directors. As the Court of Appeals stated (Meridor-Brener p. 17a):

> Schoenbaum, then, can rest solidly on the now widely recognized ground that there is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.

Moreover, the deception as charged by Goldberg, was clearly in connection with a securities sale. The corporation, UGO, was selling its stock for the transfer of Maritimecor's assets and liabilities. The deception is the failure to disclose the facts of this transaction in the two press

releases and the misdisclosure results from the inviting picture presented of the transaction. Petitioners offer no contrary authority to the Court of Appeals' view that this deception was in connection with a securities sale.*/

Thus, we submit that the law is well settled that a corporation can be deceived

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*/ Admittedly Goldberg, as a minority shareholder, was neither a purchaser nor a seller and he did not have an investment decision to make for himself. We submit that misses the point made by the majority opinion below. Goldberg's sole function in the Second Circuit's alternative analysis was as protector of UGO, a seller of securities whose ability to make an investment decision was impaired by the fraud.

even though all its directors are charged with deception. This case presents no novel principals of law relating to the Court of Appeals finding of deception in connection with a securities sale, nor any decisional conflicts on that issue that require review by this Court.

The Second Circuit Properly Found This Deception Was Material

The Second Circuit majority determined that this deception was material within the meaning of Rule 10b-5. It held that the deception was material first with respect to the corporation UGO, as represented by a reasonable and disinterested director, and then, as an alternative, with respect to minority shareholders, represented by Goldberg.

The Second Circuit's majority opinion relies on TSC Industries Inc. v. Northway

Inc., supra, for the meaning of materiality (Meridor-Brener p. 20a).

> When, as in a derivative action, the deception is alleged to have been practiced on the corporation, even though all the directors were parties to it, the test must be whether the facts that were not disclosed or were misleadingly disclosed to the shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood"that such directors would have considered the "total mix" of information available to have been "significantly altered" ...Here there is surely a significant likelihood that if a reasonable director of UGO had known the facts alleged by plaintiff rather than the barebones of the press releases, he would not have voted for the transaction with Maritimecor.

Petitioners take strong issue with this reasonable director analysis. But we urge that is the test invoked by TSC Industries Inc. v. Northway, Inc. supra.

As an alternative holding, the majority stated that the alleged deception was also material to Goldberg himself

because he had a remedy had he known the facts and not been misled by the two press releases (Meridor-Brener p. 20a). The question of whether or not Goldberg had a remedy was perhaps derived from this Court's footnote 14 to its Santa Fe opinion where it referred to the secondary argument raised by the minority shareholder that the lack of advance notice of the merger was a material nondisclosure under Rule 10b-5. This Court rejected the argument because there was no showing of what the shareholder could have done differently had he received advance notice. The minority shareholder had accepted the conclusion that he could not have enjoined the merger under state law. But most importantly, in rejecting the argument, this Court emphasized that there was no requirement that advance notice of the merger be given. Thus, there was nothing

inherently wrong in not giving the notice, and the burden was placed on the shareholder to show what course of action he would have taken had he received the notice. This is far different from the nondisclosure and deception by the UGO directors which are inherently wrong.

We, therefore, submit that the Second Circuit's majority opinion is entirely consistent with both this Court's holding in TSC Industries v. Northway Inc., supra and footnote 14 to the opinion in Santa Fe v. Green, supra.

The New York Security For Costs Statute is Not Applicable

Petitioners ask this Court to apply the New York security for costs statute, New York Business Corporation Law § 627, to claims under Section 10(b) and Rule 10b-5.

If this is a federal claim under 10(b)

as the majority opinion below decided, there is no valid reason why a state security for costs provision should be applied. This was squarely presented by McClure v. Borne Chem. Co., 292 F.2d 824 (3rd Cir. 1961) and this Court denied certiorari at 368 U.S. 939 (1961). Petitioners offer no valid reason why the issue should now be considered.

Petitioners' Argument That This Suit is Barred by the Law of Panama Does not Merit Review

Petitioners argue that the law of Panama controls, and that a derivative suit on behalf of a corporation is not permitted under Panama law. Hence they argue this action must be dismissed. This point was raised for the first time by petitioners on their application for re-argument to the Court of Appeals and it was rejected without opinion (Singer p. 46a). We submit that where there are United States shareholders and UGO has its principal place

of business in New York, Panama law would not be applied to defeat an action brought pursuant to a United States statute, to wit, Section 10(b) of the Securities Exchange Act. See for example, Miller v. Steinbach, 268 F.Supp. 255, 266-9 (S.D.N.Y. 1967). This Court has expressed the same view in J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted,

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